

PUBLIC SERVICE COMMISSION OF WISCONSIN**Memorandum**

August 7, 2002

FOR COMMISSION AGENDA

TO: The Commission

FROM: David Albino, Administrator *DA*
 Gary Evenson, Assistant Administrator *HAZ*
 Kevin H. Klingbeil, Audit Manager *HHK*
 Telecommunications Division

RE: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives

Request by Wisconsin Incumbent Local Exchange Telecommunications Cooperatives for a Commission Accounting Order in Docket 05-US-102 for Two New Subaccounts for Account 4550, Retained Earnings, and a New Account 4511, Members Equity

Suggested Minute: The Commission (approved the cooperatives' request/decided to utilize docket 05-US-113 to consider the cooperatives' request/requested additional comments from cooperatives and other interested parties in a separate proceeding/denied the cooperatives' request) to establish two new subaccounts 4550.1, Retained Earnings-Patronage Capital Unassigned, and 4550.2, Retained Earnings-Patronage Capital Assigned, and to create a new account 4511, Members Equity, in the uniform system of accounts for incumbent local exchange carrier telephone utilities.

The purpose of the memorandum is to address the need for, and process of considering, accounting changes applicable to telephone cooperatives.¹

In December 2001, staff advised telephone cooperatives to implement accounting changes for patronage capital consistent with the Commission's Chibardun Order.² The cooperatives are proposing an alternative accounting treatment.

¹ There are 11 cooperatives in Wisconsin: Chequamegon Telephone Cooperative, Inc.; Chibardun Telephone Cooperative, Inc.; Citizens Telephone Cooperative, Inc.; Cochrane Cooperative Telephone Company; LaValle Telephone Cooperative; Marquette-Adams Telephone Cooperative, Inc.; Nelson Telephone Cooperative; Richland-Grant Telephone Cooperative, Inc.; Tri-County Telephone Cooperative, Inc.; Vernon Telephone Cooperative, Inc.; and West Wisconsin Telcom Cooperative, Inc.

² Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc., of its Subsidiaries and of Possible Related Violations, docket no. 1090-TI-100, order dated November 16, 2001 (Chibardun Order).

Background

One of the many issues addressed late last year in the Chibardun Order was the treatment of patronage capital; specifically whether it was part of retained earnings. The above-referenced order contains extensive discussion concerning the patronage capital of Chibardun Telephone Cooperative, Inc. (Chibardun), in the section labeled "The Status of Patronage Capital" on pages 20-22. (These pages are attached to this memorandum as Attachment A.)

In the Chibardun Order, the Commission stated (page 11; Finding of Fact number 12):

12. To properly account to the Commission for patronage capital, patronage capital should be included in account 4520 of the Uniform System of Accounts (as adopted by the Commission) as "additional paid in capital."

In addition, the Commission stated on page 13 in Conclusion of Law number 5:

5. Chibardun's patronage capital is not part of retained earnings, within the meaning of Wis. Stat. § 196.204(1).

As a follow-up to the Chibardun Order, David Albino, Administrator of the Commission's Telecommunications Division, issued a letter on December 17, 2001, to the 11 incumbent local exchange telecommunications cooperatives in the state (including Chibardun) that addressed accounting treatment for patronage capital by cooperatives. A copy of this letter is attached to this memorandum (see Attachment B). Mr. Albino's letter requested that, consistent with the Commission's finding in docket 1090-TI-100, each cooperative reclassify its patronage capital to account 4520, Additional Paid-in Capital, by December 31, 2001, and reflect such classification in its 2001 incumbent local exchange carrier annual report to be filed with the Commission. That letter requested each cooperative to confirm in writing that this change was being made or, in the alternative, to inform the Commission of the "particulars constituting alternate classification."

On April 3, 2002, the last of the 11 responses from the cooperatives was received. A copy of each of the responses is attached to this memorandum (see Attachment C). The responses are very uniform. Each response basically indicates the following:

1. The cooperative disagrees with the staff conclusion concerning the Uniform System of Accounts (USOA);
2. Patronage capital does not qualify for inclusion in account 4520, Additional Paid-in Capital;
3. The cooperative intends to use the following in closing the books for calendar year 2001. The cooperative will use two separate subaccounts (4550.1, Retained Earnings - Patronage Capital Unassigned, and 4550.2, Retained Earnings - Patronage Capital Assigned) to record undistributed amounts derived from operations of the cooperative;
4. The cooperative requests a new account 4511, Members Equity; and
5. The cooperative requests that the Commission issue an accounting order in docket 05-US-102, adopting the 4550.1 and 4550.2 subaccounts and a new 4511 account for cooperatives effective December 31, 1988.

In addition, Citizens Telephone Cooperative, Inc.; Marquette-Adams Telephone Cooperative, Inc.; Nelson Telephone Cooperative (Nelson); and West Wisconsin Telcom Cooperative, Inc., further posit that the federal Rural Utilities Service (RUS), the Rural Telephone Finance Cooperative (RTFC), and other financial institutions that lend money to cooperatives recognize patronage capital the same as retained earnings to measure financial strength. These cooperatives state that historically patronage capital has been presented as earnings retained in the cooperative, and that the cooperative determines when assigned and unassigned patronage capital is returned to members in the same manner as when a corporation determines when dividends are declared and paid.

The Wisconsin Federation of Cooperatives (WFC) provided additional information in support of the cooperatives' request on June 4 and July 31, 2002. These are attached as Attachments D and E, respectively.

Analysis

The cooperatives have expressed a position on the treatment of patronage capital at odds with that expressed by staff in advising them of the Chibardun decision. The Chibardun proceeding was long and controversial, and the Commission affirmed the finding that for Chibardun, the patronage capital was not appropriately considered to be part of retained earnings. The cooperatives, though making a request for subaccounts, the creation of a new account (Members Equity) and an effective date of December 31, 1988,³ have offered limited reasoning for that accounting treatment.

If the Commission affirms the Chibardun-like treatment of the patronage capital, applies the Chibardun decision to accounting practice for all telecommunications cooperatives, and dismisses the cooperatives' request, there would be uniformity in how the 11 cooperatives are recording and reporting these patronage amounts.

On the other hand, though the cooperatives' requests may be lacking in substantive argument, the opening of a uniform system of accounts (or separate) proceeding to evaluate the

³ It is not clear why this accounting change should be retroactive to December 31, 1988. There is no evident practical need for this date. It does not even coincide with the January 1, 1988 effective date of the current USOA adopted by the Commission in 1987. One possible explanation for the retroactive application of the accounting treatment is that the cooperatives seek, in effect, to indirectly "immunize" past subsidization activities that would violate Wis. Stat. § 196.204(1), particularly those activities paralleling the facts of the Chibardun order, including counting of patronage capital as retained earnings in order to increase the permissible subsidization under Wis. Stat. § 196.204(1).

suggestions more would allow all sides on this issue to make a more complete case, without redoing the basic Chibardun decision which was and is still effective for that cooperative.⁴

In the Chibardun case, the Commission noted (at page 21 of the Chibardun Order), that the specific language in Chibardun's bylaws warranted classification of patronage capital in account 4520, Additional Paid-in Capital, because, in effect, it has been distributed, in contrast to the "undistributed balance of retained earnings" language contained in the definition of account 4550, Retained Earnings, and that Chibardun's bylaws characterize it as being furnished "for capital."⁵

Commission staff requested and reviewed the bylaws of the other 10 cooperatives. The language concerning patronage capital in all of the cooperatives' bylaws is similar to or identical to Chibardun's language (cited in footnote 5) which was reviewed in depth in docket 1090-TI-100. However, Nelson's bylaws contain a supplemental provision similar to Chibardun's as follows:

All other amounts received by the Cooperative from non-regulated or non-operating income, ..., in excess of operating costs and expenses properly chargeable against the furnishing of such services, ..., shall insofar as permitted by law:

- 1) Be reserved as unallocated retained earnings, and shall not be allocated to the Cooperative's patrons on a patronage basis as a part of the capital credited to the accounts of patrons, as herein provided.
- 2) Be used for business purposes as determined by the Cooperative.

⁴ Historically, any changes to the uniform system of accounts for telecommunications utilities have been addressed in docket 05-US-102. On that basis to open an investigation there has precedent. However, it is anticipated that the Commission may be opening docket 05-US-113 this year to address more substantive changes to the uniform system of accounts that were recently adopted by the Federal Communications Commission in 47 C.F.R. Part 32. If the Commission decides to open a separate review of this patronage capital issue, another, separate "US" docket may be appropriate.

⁵ The Chibardun bylaws state in part: "All such amounts credited to the capital amount of any patron shall have the same status as though paid to the patron in cash in pursuance of a legal obligation to do so and the patron has then furnished the Cooperative corresponding amounts for capital."

Given the similarities in bylaw language among the cooperatives, the application to others of the accounting directives from the Chibardun case is fully logical, either to a subset or all of the other cooperatives.

On July 24, 2002, a Commission staff meeting was held to discuss possible revisions to the uniform system of accounts for Class A and Class B telephone utilities.⁶ At that meeting, Bradley D. Jackson of Foley & Lardner, outside counsel for CenturyTel, stated that CenturyTel will contest the cooperatives' proposed accounting classification of patronage capital. The consensus of the assembled group was that this patronage capital issue should be addressed outside of docket 05-US-113. The cooperatives would like the patronage capital issue placed on a fast track and addressed outside of docket 05-US-113. On July 31, 2002, Warren Day, Attorney for the WFC, filed a second letter concerning this issue, requesting an immediate decision by the Commission concerning the pending patronage capital accounting requests. No written comments have been requested from other parties, including CenturyTel and Marcus Cable Partners, LLC (Marcus), the latter of whom was a party in docket 1090-TI-100 concerning Chibardun.

Although Chibardun filed a letter very much the same as all the other cooperatives on the account treatment, the Commission staff notified Chibardun in a letter dated March 25, 2002, that it is bound by the Commission's Order and requested copies of journal entries evidencing compliance with the Order. A brief review of the filed 2001 cooperative annual reports shows that Chibardun is the only cooperative with a year-end balance in account 4520, Additional Paid-in Capital.

⁶ The Commission's docket addressing revisions to this uniform system of accounts has been provisionally assigned docket 05-US-113, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities.

The WFC comments cite several arguments on treatment of patronage capital; however, none specifically negate the Commission's earlier finding in Chibardun as it relates to the bylaws as written and the Wisconsin Statutes in ch. 196. Further, concerns about inconsistent accounting between the Commission's approach and those of the Internal Revenue Service or RUS do not mandate a uniform treatment under the law.

Options

In determining how to address this matter, the Commission has various options:

Option 1. Approve the request of some or all of the cooperatives, and direct staff to prepare an order to create the subaccounts and the account requested. However, under this approach the Commission may have to decide how to address Chibardun, which is currently covered by the terms of its November 16, 2001 order. In addition, the Commission would have to determine whether to use the December 31, 1988 effective date as requested (or January 1, 1988 to coincide with the effective date of the current USOA) or to establish a more recent date for conversion of the uniform system of accounts for telephone cooperatives. This approach provides certainty for the cooperatives; however, it does not address the need, if any, to give particular and separate treatment to Chibardun and Nelson because of the specific and unique bylaw provisions they have for treatment of non-regulated or non-operating income, nor does it provide for consideration of opposing views that may be held by other interested persons (e.g., CenturyTel or Marcus).

Option 2. Open a docket on the patronage capital accounting issue. This could be in docket 05-US-113 or in a separate docket. In such a docket, the Commission could request formal comments from the 11 cooperatives (including Chibardun) and interested parties (e.g., CenturyTel and Marcus) regarding this issue.

Option 3. Deny the cooperatives' requests; affirm the staff accounting directive from the December 17, 2001 letter and require accounting as therein specified. This action confirms the Commission views expressed in 1090-TI-100 relative to the bylaw language used by all the cooperatives (see footnote 5).

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Attachments

Docket 1090-TI-100

exceeds “retained earnings,” which is only a sub-part of the whole company’s net worth.

Although difficult to quantify due to its uncapped and contingent nature, the value of the guarantee given by Chibardun is best measured by the value implicit in Chibardun’s promise, the company’s net worth, which, in turn is best related to the company’s balance sheet net worth.

The key fact is that RTFC wanted the guarantee, without which it would not have provided the financing for these start-up ventures. Therefore, Chibardun’s net worth, not merely its “retained earnings,” subsidized the economic foundation of the entire loan transaction. Thus, Chibardun’s guarantee as a practical economic matter exceeds the dollar limitation inherent in the accounting term, “retained earnings,” and thereby violates the “except for retained earnings” limitation on subsidization in the first sentence of Wis. Stat. § 196.204(1). To the extent the subsidy exceeded Chibardun’s retained earnings at the time the first loan was made and continues to exceed Chibardun’s retained earnings for every year the guarantee remains in effect, Chibardun provided and is continuing to provide a subsidy in violation of Wis. Stat. § 196.204(1).

This conclusion is far from ineluctable. The legislature knew how to directly prohibit a loan guarantee when it wanted to. In Wis. Stat. § 196.525, it regulated a utility’s “lend[ing] of credit.” In Wis. Stat. § 196.795(5)(d), it expressly prohibited a public utility affiliate from “guarantee[ing] the obligations” of a nonutility affiliate. The legislature has also, quite clearly, eased regulation of telecommunications utilities: neither of these statutes applies to them.

The Status of Patronage Capital

To what extent the value of the guarantee’s indirect subsidy exceeds Chibardun’s retained earnings depends upon the characterization of Chibardun’s “patronage capital.” If patronage

capital is not part of retained earnings¹⁴, the subsidies exceed retained earnings to a greater extent than if a part of retained earnings.

The Commission has adopted relevant sections of the Uniform System of Accounts. Account § 4550 is entitled "Retained Earnings." Section 4550(1) states: "This account shall include undistributed balance of retained earnings derived from the operations of the company and from all other transactions not includable in the other accounts appropriate for the inclusion of stockholders' equity." Under Chibardun's bylaws, all amounts "received and receivable from the furnishing of [regulated telecommunications] services in excess of operating costs and expenses" are credited to the patrons' capital accounts with "the same status as though paid to the patron in cash in pursuance of a legal obligation to do so." Although immediately deemed furnished to the cooperative as "corresponding amounts for capital"—in effect, paid back in—the revenues have been distributed.

Mr. Klingbeil believes that cooperatives should account for patronage capital as "Additional Paid-in Capital," under § 4520. Chibardun's accountant, Mr. Meier, testified that patronage capital does not fit the definition of additional paid-in capital. Given that everybody refers to these amounts as patronage "capital," and measured along side Chibardun's bylaw characterizing patronage capital as being furnished "for capital," Mr. Klingbeil's is the more reasonable interpretation.

Chibardun itself recognizes patronage capital as something other than retained earnings. Its 1996 bylaws amendment introduced the term "retained earnings," distinguishing it from patronage capital. Also, Chibardun's audited financial statements separately listed retained

¹⁴ For Chibardun's accounting, the term "retained capital" is synonymous with "retained earnings."

capital and patronage capital, and Chibardun's auditor believes that retained capital is the equivalent for cooperatives of retained earnings.

Still, the Commission does not fault Chibardun's accountants (and management) for characterizing patronage capital as retained earnings. Cooperative accounting appears fairly complex. See Emmanuel S. Tipon, *Annotation: Co-Operative Associations: Rights in Equity Credits or Patronage Dividends*, 50 A.L.R. 3d 435 (1973). The Commission has no rules regarding the accounting for public utilities that are specific only to cooperatives. The annual report utilized by the Commission does not provide a place to account for patronage capital. Nor, are there authorities—either technical or legal—out there to guide companies like Chibardun. Under these circumstances, Chibardun's accounting judgments were not egregious.

In light of this and the preceding sections, the Commission finds that Chibardun's uncapped guarantee for its affiliate obligations to the RTFC exceeded the level of "retained earnings," which does not include patronage capital. This subsidy commenced in 1997 and continues today. Its calculation is detailed in Confidential Appendix B of the staff's Post-Hearing Brief (Column G, in particular), incorporated herein by reference.¹⁵

The Size of the Direct Subsidy

Staff testified in this proceeding that the additional value of the guarantee to the affiliates is equal to the amount the affiliates saved by not having had to pay a higher rate of interest or having had to obtain bond insurance. Chibardun did not charge the affiliates for this economic

¹⁵ Confidential Exhibit 4 provided extensive income statement and balance sheet information for the years in question. Simple reference to the footnotes shows the amount of guaranteed RTFC borrowings and Chibardun's much lower retained earnings, labeled "retained capital." The relevant figures were tabulated and summarized in Confidential Appendix B to staff's Post-Hearing Brief, dated May 25, 2001.



Public Service Commission of Wisconsin

Ave M. Bie, Chairperson
Joseph P. Mettner, Commissioner
Robert M. Garvin, Commissioner

ATTACHMENT B

610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

December 17, 2001

TO: Wisconsin Incumbent Local Exchange Telecommunications
Cooperatives

Reply Required

Re: Accounting Treatment for Patronage Capital by
Telecommunications Cooperatives

File TELACCTG

In its order dated November 16, 2001, in *Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc., of its Subsidiaries and of Possible Related Violations*, docket 1090-TI-100, the Commission concluded that Chibardun Telephone Cooperative, Inc.'s patronage capital is not part of account 4550, Retained Earnings, within the meaning of Wis. Stat. § 196.204(1), but rather should be classified in account 4520, Additional Paid-in Capital, based on the distributed nature of patronage capital under that cooperative's bylaws.

By order dated October 1, 1987, in docket 05-US-102, *In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities*, the Commission adopted the following language for subsection (a) of account 4550, effective January 1, 1988:

(a) This account shall include the undistributed balance of retained earnings derived from the operations of the company and from all other transactions not includable in the other accounts appropriate for inclusion of stockholders' equity.

In effect, the Commission's order in docket 1090-TI-100 clarifies that patronage capital does not qualify as an "other transaction" includable in retained earnings under subsection (a) of account 4550.

The above accounting treatment should be implemented by all incumbent local exchange telecommunications cooperatives in Wisconsin. At the present time, the following telecommunications cooperatives are operating in the state:

1. Chequamegon Telephone Cooperative, Inc.
2. Chibardun Telephone Cooperative, Inc.
3. Citizens Telephone Cooperative, Inc.
4. Cochrane Cooperative Telephone Co.
5. LaValle Telephone Cooperative, Inc.
6. Marquette-Adams Telephone Cooperative, Inc.
7. Nelson Telephone Cooperative
8. Richland-Grant Telephone Cooperative, Inc.
9. Tri-County Telephone Cooperative, Inc.
10. Vernon Telephone Cooperative
11. West Wisconsin Telcom. Coop. Inc.

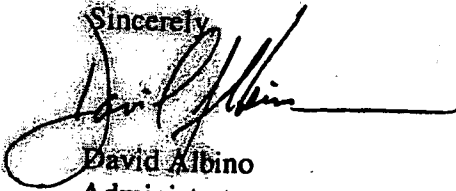
Wisconsin Incumbent Local Exchange Telecommunications Cooperatives
File TELACCTG
Page 2

Consistent with the Commission's finding in docket 1090-TI-100, each cooperative should reclassify its patronage capital to account 4520, Additional Paid-in Capital, by December 31, 2001, and reflect such classification in its 2001 incumbent local exchange carrier annual report to be filed with the Commission on or before April 1, 2002. The reclassification is consistent with Wis. Stat. § 185.45(3), stating that "[u]nless the articles or bylaws otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative but all thereof shall be distributed and paid to patrons, whether members or not." A cooperative's articles or bylaws may provide, however, that any of the net proceeds be credited to allocated or unallocated surplus or reserves of the cooperative, in which case such net proceeds would not be considered patronage capital. See Wis. Stat. § 185.45(4)(a).

Please confirm by letter that this change is being made. If a cooperative believes that all or a portion of its patronage capital does not qualify for classification in account 4520, that entity shall inform the Commission of the particulars constituting alternate classification prior to the closing of that entity's books for calendar year 2001.

If you have any questions concerning the above-specified accounting treatment for patronage capital by telecommunications cooperatives, please contact Kevin Klingbeil at (608) 267-9504.

Sincerely,



David Albino
Administrator
Telecommunications Division

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cc: Ray Riordan, Executive Vice President, Wisconsin State Telecommunications Association, Inc. (WSTA)
Gerald A. Ringlund, Chairman, WSTA Accounting Committee



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DIVISION

ATTACHMENT C

WISCONSIN PUBLIC SERVICE
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January 31, 2002

CHEQUAMEGON

TELEPHONE

COOPERATIVE

INCORPORATED

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications
Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts.

Wisconsin USOA Part 32 account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§ 32.4520 Additional Paid-in Capital

- (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.
- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to

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CABLE WI 54821

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715.798.3303

FAX

715.798.3044

[HTTP://WWW.CHEQTEL.COM](http://www.cheqtel.com)

the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types.

Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines.

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

- (a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings – Patronage Capital Assigned

- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the cooperative. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the cooperative's business purpose.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings - Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings - Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

In addition to the above two accounts, we are requesting a new account as follows:

§ 32.4511 Members Equity

- (a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.
- (b) Subsidiary records shall be maintained so as to show separately each class of membership.
- (c) This account shall be charged with the book amount of any memberships retired.

We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

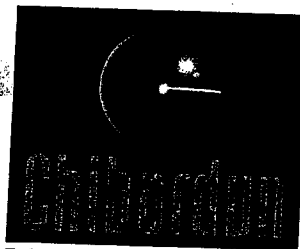
Thank you for your review of this letter. Please call me at 715-798-3303 if you have any further questions.

Sincerely,

David J. Carter

David J. Carter
General Manager

PO BOX 104, 110 N. SECOND AVENUE
DALLAS, WI 54733
TELEPHONE: 715.837.1011
TOLL FREE: 1.800.924.3405
FAX: 715.837.1196



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COMMUNICATING SOLUTIONS.
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CTC WIRELESS
CTC TELCOM
CTC CABLE
CTC NET

March 4, 2002

David Albino, Administrator
Telecommunications Division
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Madison, WI 53707-7854

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TELECOMMUNICATIONS
DIVISION

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

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We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts.

Wisconsin USOA Part 32 account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§ 32.4520 Additional Paid-in Capital

- (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.
- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types.

Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines:

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

- (a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings – Patronage Capital Assigned

- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the cooperative. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the cooperative's business purpose.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings - Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings - Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

In addition to the above two accounts, we are requesting a new account as follows:

§ 32.4511 Members Equity

- (a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.
- (b) Subsidiary records shall be maintained so as to show separately each class of membership.
- (c) This account shall be charged with the book amount of any memberships retired.

We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for your review of this letter. Please call me at 715-837-1014 if you have any further questions.

Sincerely,



Rick Vergin
Chief Executive Officer
Chibardun Telephone Cooperative, Inc.



CITIZENS TELEPHONE COOPERATIVE, INC.

328 W. Main Street

P.O. Box 127
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New Auburn, WI 54757-0127

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March 25, 2002

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File TELACCTG

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This letter is in response to your December 17, 2001, letter requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts. The Rural Utilities Service (RUS), Rural Telephone Finance Cooperative (RTFC) and other financial institutions that lend money to Cooperatives, recognize Patronage Capital the same as Retained Earnings. Retained Earnings-Patronage Capital is used by lenders to measure financial strength for lending decisions.

Wisconsin USOA Part 32 Account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§32.4520 Additional Paid-in Capital

- (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.
- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types. Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines.

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

- (a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings – Patronage Capital Assigned

- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the Cooperative per the Cooperative's bylaws. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the cooperative's business purpose.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings-Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings-Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

We are requesting adoption of the sub-accounts above because we have historically presented the patronage capital of the Cooperative as earnings retained in the Cooperative. The Cooperative, with bylaw authority, determines when assigned and unassigned patronage capital is returned to members in the same manner as a Corporation, with bylaw authority, determines when dividends are declared and paid.

In addition to the above two accounts, we are requesting a new account as follows:

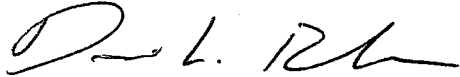
§ 32.4511 Members Equity

- (a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.
- (b) Subsidiary records shall be maintained so as to show separately each class of membership.
- (c) This account shall be charged with the book amount of any memberships retired.

We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for your review of this letter. Please call me at 715-237-2605 if you have any further questions.

Sincerely,

A handwritten signature in dark ink, appearing to read "D.L. Bachman", with a stylized flourish at the end.

Dennis Bachman
General Manager

DLB/rmg



103 West 5th Street

P.O. Box 189

Cochrane, WI 54622-0189

☐ 608-248-2323

☐ 608-248-2113

☐ cochrane@mwt.net

☐ <http://www.mwt.net/~cochrane>

WISCONSIN PUBLIC SERVICE
COMMISSION

2002 FEB -8 P 3:22

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FEB - 8 2002

**TELECOMMUNICATIONS
DIVISION**

January 31, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts.

Wisconsin USOA Part 32 account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§ 32.4520 Additional Paid-in Capital

- (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.
- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this

account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types.

Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines.

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

- (a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings – Patronage Capital Assigned

- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the cooperative. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the cooperative's business purpose.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings - Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings - Patronage Capital Assigned are as follows:

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In addition to the above two accounts, we are requesting a new account as follows:

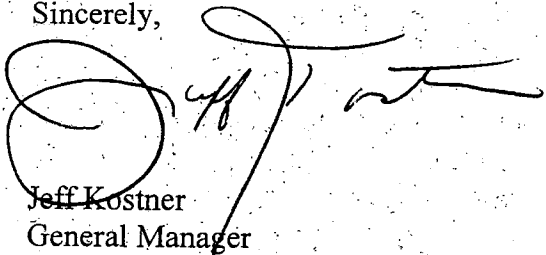
§ 32.4511 Members Equity

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We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for your review of this letter. Please call me at 608-248-2323 if you have any further questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Jeff Kostner", written over a large, stylized circular flourish.

Jeff Kostner
General Manager



WISCONSIN PUBLIC SERVICE
COMMISSION

2002 MAR 15 4 10 26

RECEIVED

RECEIVED

MAR 15 2002

TELECOMMUNICATIONS
DIVISION

March 14, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts.

Wisconsin USOA Part 32 account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§ 32.4520 Additional Paid-in Capital

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- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock, otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types.

Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines.

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

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- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

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- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings - Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings - Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

In addition to the above two accounts, we are requesting a new account as follows:

§ 32.4511 Members Equity

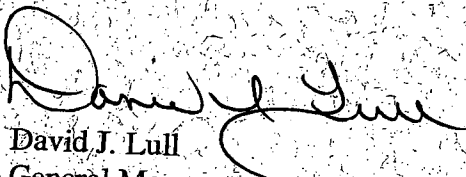
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We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for you review of this letter. Please call me at 608-985-7201 if you have any further questions.

Sincerely,



David J. Lull
General Manager

DJL/wsg

2002 MAR 18 A 9:24

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MAR 18 2002

TELECOMMUNICATIONS
DIVISION

March 13, 2002

David Albino, Administrator
Telecommunications Division
Wisconsin Public Service Commission
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives File
TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts. The Rural Utilities Service (RUS), Rural Telephone Finance Cooperative (RTFC) and other financial institutions that lend money to Cooperatives recognize Patronage Capital the same as Retained Earnings. Retained Earnings-Patronage Capital is used by lenders to measure financial strength for lending decisions.

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§ 32.4520 Additional Paid-in Capital (Continued)

- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

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- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the Cooperative per the Cooperative's bylaws. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the Cooperative's business purpose.
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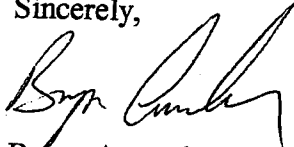
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Thank you for your review of this letter. Please call me at 608-586-4111 if you have any further questions.

Sincerely,



Bryan Amundson, General Manager
Marquette-Adams Telephone Cooperative, Inc.

318 Third Avenue West
P.O. Box 228
Durand, Wisconsin 54736
Phone 715-672-4204



NELSON TELEPHONE CO-OPERATIVE

WISCONSIN PUBLIC SERVICE
COMMISSION

2002 MAR 28 A 10:35

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MAR 28 2002

TELECOMMUNICATIONS
DIVISION

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March 25, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts. The Rural Utilities Service (RUS), Rural Telephone Finance Cooperative (RTFC) and other financial institutions that lend money to Cooperatives recognize Patronage Capital the same as Retained Earnings. Retained Earnings-Patronage Capital is used by lenders to measure financial strength for lending decisions.

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Patronage capital does not meet either one of these transaction types. Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines.

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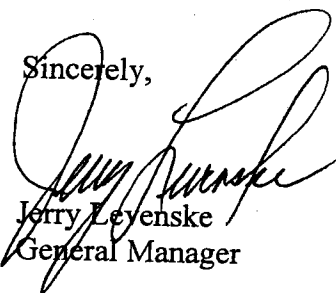
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Thank you for you review of this letter. Please call me at 715-672-4204 if you have any further questions.

Sincerely,



Jerry Leyenske
General Manager

JLL/saw



Richland-Grant

Telephone Cooperative, Inc.

202 N. EAST ST. • P.O. BOX 67 • BLUE RIVER, WISCONSIN 53518-0067 • PHONE (608) 537-2461 • FAX (608) 537-2222

2002 MAR -4 A 10:22

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MAR - 4 2002

TELECOMMUNICATIONS
DIVISION

March 1, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

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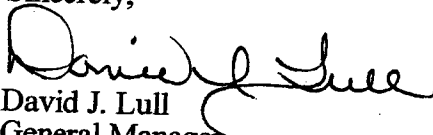
§ 32.4511 Members Equity

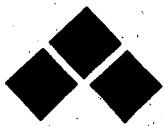
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Thank you for your review of this letter. Please call me at 608-537-2461 if you have any further questions.

Sincerely,


David J. Lull
General Manager



Tri-County Telephone cooperative

417 5TH AVENUE NORTH
P.O. BOX 578
STRUM, WI 54770-0578

STRUM 715/695/2691
FAX 715/695/3599

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FEB 11 2002
TELECOMMUNICATIONS
DIVISION

FEB 11 A 10:21

DISCOUNT SERVICE

February 8, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

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In addition to the above two accounts, we are requesting a new account as follows:

§ 32.4511 Members Equity

- (a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.

- (b) Subsidiary records shall be maintained so as to show separately each class of membership.
- (c) This account shall be charged with the book amount of any memberships retired.

We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for your review of this letter. Please call me at 715-695-2691 if you have any further questions.

Sincerely,

A handwritten signature in cursive script, appearing to read "Fred W. Weier".

Fred W. Weier
General Manager

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TELECOMMUNICATIONS
DIVISION

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WISCONSIN PUBLIC SERVICE
COMMUNICATIONS

February 14, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives
File TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts.

Wisconsin USOA Part 32 account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§ 32.4520 Additional Paid-in Capital

- (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.
- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types.

Our intention in closing our books for the year ended December 31, 2001, will be to follow these guidelines.

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings – Patronage Capital Unassigned

- (a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings – Patronage Capital Assigned

- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the cooperative. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the cooperative's business purpose.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings - Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings - Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

In addition to the above two accounts, we are requesting a new account as follows:

§ 32.4511 Members Equity

- (a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.
- (b) Subsidiary records shall be maintained so as to show separately each class of membership.

(c) This account shall be charged with the book amount of any memberships retired.

We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for your review of this letter. Please call me at 608-634-7421 if you have any further questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Rod Olson", with a large, stylized initial "R" and "O".

Rod Olson
General Manager



P.O. Box 115
Downsville, WI 54735
715-664-8311
715-664-9982 FAX

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MAR 26 2002

TELECOMMUNICATIONS
DIVISION

March 21, 2002

David Albino, Administrator
Telecommunications Division
610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

Re: Accounting Treatment for Patronage Capital by Telecommunications Cooperatives File
TELACCTG

Dear Mr. Albino:

This letter is in response to your December 17, 2001 letter, requesting that all Wisconsin Incumbent Local Exchange Telecommunications Cooperatives report patronage capital as Additional Paid-in Capital by December 31, 2001.

We want to first state that we do not agree with your interpretation of the USOA Part 32 uniform system of accounts. The Rural Utilities Service (RUS), Rural Telephone Finance Cooperative (RTFC) and other financial institutions that lend money to Cooperatives recognize Patronage Capital the same as Retained Earnings. Retained Earnings-Patronage Capital is used by lenders to measure financial strength for lending decisions.

Wisconsin USOA Part 32 account 4520 Additional Paid-in Capital only allows for two types of transactions to be included:

§ 32.4520 Additional Paid-in Capital

- (a) This account shall include the difference between the net proceeds (including discount, premium and stock issuance expense) received from the issuance of capital stock and the amount includable in Account 4510, Capital Stock, unless such difference results in a debit balance for that class of stock, in which case the amount shall be charged to Account 4550, Retained Earnings.

We're the *link* to your connection.

§ 32.4520 Additional Paid-in Capital (Continued)

- (b) This account shall also include gains arising from the retirement and cancellation of capital stock. Losses from the retirement and cancellation of capital stock shall be charged to this account to the extent that there exist credits in this account for the same class of stock; otherwise to Account 4550.

Patronage capital does not meet either one of these transaction types. Our intention in closing our books for the year ended December 31, 2001, will be to follow the following guidelines.

Our Cooperative will use two separate accounts to record all the undistributed amounts derived from the operations of the cooperative. These accounts are as follows:

§ 32.4550.1 Retained Earnings — Patronage Capital Unassigned

- (a) This account shall include the undistributed and unassigned balance of retained earnings derived from the operations of the cooperative and from all other transactions not includable in the other accounts appropriate for inclusion of equity.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

§ 32.4550.2 Retained Earnings — Patronage Capital Assigned

- (a) This account shall include the undistributed and assigned to members of retained earnings derived from the operations of the Cooperative per the Cooperative's bylaws. These amounts have been designated or set aside by the cooperative's board of directors to be used for the further development and advancement of the Cooperative's business purpose.
- (b) Subsidiary records shall be maintained wherein are recorded all entries to retained earnings during the year such that the detail of the entries may be disclosed to this commission.

Amounts includable in A/C 32.4550.1 Retained Earnings - Patronage Capital Unassigned are as follows:

- Current year unassigned net income from operations.
- Patronage capital unassigned from prior years reserved for future cooperative operations.
- All other unassigned amounts.

Amounts includable in A/C 32.4550.2 Retained Earnings - Patronage Capital Assigned are as follows:

- All patronage capital assigned to members but undistributed.

Mr. David Albino, Administrator

March 21, 2002

We are requesting adoption of the sub-accounts above because we have historically presented the patronage capital of the Cooperative as earnings retained in the Cooperative. The Cooperative, with bylaw authority, determines when assigned and unassigned patronage capital is returned to members in the same manner as a Corporation, with bylaw authority, determines when dividends are declared and paid.

In addition to the above two accounts, we are requesting a new account as follows:

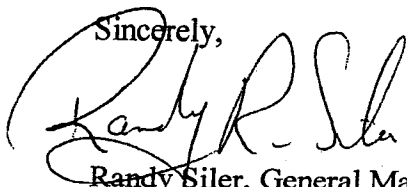
§ 32.4511 Members Equity

- (a) This account shall include the par value, stated amount, or in the case of no-par, the amount received for memberships issued and outstanding.
- (b) Subsidiary records shall be maintained so as to show separately each class of membership.
- (c) This account shall be charged with the book amount of any memberships retired.

We request that the Public Service Commission of Wisconsin issue an accounting order in Docket 05-US-102, In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B telephone Utilities, adopting these sub-accounts for telephone cooperatives effective December 31, 1988.

Thank you for your review of this letter. Please call me at 715-664-8311 if you have any further questions.

Sincerely,

A handwritten signature in black ink, appearing to read "Randy R. Siler", written over a circular stamp or seal.

Randy Siler, General Manager
West Wisconsin Telcom Cooperative, Inc.



Wisconsin Federation of Cooperatives

131 West Wilson Street, Suite 400, Madison, WI 53703
Phone: 608.258.4400 Fax 608.258.4407 www.wfcmac.org wfcmac@wfcmac.org

ATTACHMENT D

June 4, 2002

Ms. Lynda Dorr, Secretary
Public Service Commission of Wisconsin
P. O. Box 7854
Madison, WI 53707-7854

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JUN - 5 2002

TELECOMMUNICATIONS
DIVISION

In re: Accounting Treatment for Patronage Capital of Telecommunications
Cooperatives - File TELACCTG

Dear Ms. Dorr:

The Wisconsin Federation of Cooperatives (WFC) files this letter in the above-referenced matter to help clarify the sometimes-confusing accounting and economic theory and practices of cooperatives. We have observed the considerable amount of argument, including recent efforts to change Chapter 196, to accommodate the established method by which cooperatives capitalize ongoing and new ventures. Our intent is to explain how cooperatives operate financially under various laws (primarily the Internal Revenue Code (IRC)), the Rural Utilities Service, and generally accepted accounting principles and thereby support the cooperatives' requests for a modification of PSC 05-US-102 relating to the PSC Uniform System of Accounts (USOA).

Summary

- The Public Service Commission of Wisconsin (PSC) directive (David Albino letter order of 12-17-01 (Attachment 1) to classify "patronage capital" as "additional paid-in capital" is inconsistent with long-established cooperative accounting and tax law.
- The reclassification will deprive the cooperatives of their primary source of equity capital. The Rural Utilities Service (RUS), Rural Telephone Finance Cooperative (RTFC) and other financial institutions that lend money to Cooperatives recognize Patronage Capital the same as Retained Earnings. Retained Earnings-Patronage Capital is used by lenders to measure financial strength for lending decisions.
- The RUS (formerly REA) recommended the bylaw language at least as early as 1964 in its guidance to telephone cooperatives. REA Bulletin 402-3 (1964) (Attachment 2). Longstanding caselaw and tax court rulings (cited below) also are the legal foundation for operation on a cooperative basis. Adopting the changes suggested by

the cooperatives will keep PSC rules in harmony with overriding federal tax law, RUS requirements, and Chapter 185, Wis. Stats. (Attachment 3.)

- It is unreasonable to suggest, as the letter order does, that cooperative adopt new bylaws to accommodate the PSC's interpretation of cooperative accounting. The bylaws are rooted in a complex web of law and federal agency rulings. (Bylaw changes also require great time and expense to each cooperative.)
- Unless the letter order is modified, the cooperatives will be subjected to extraordinary regulation by the PSC which a) jeopardizes the ability of the telecommunications cooperatives to operate financially, and b) puts all telecommunications cooperatives at a competitive disadvantage.
- WFC supports the proposal filed by the telecommunications cooperatives in response to Mr. Albino's letter. They ask the commission to create new subcategories of "retained earnings" for a) assigned and b) unassigned patronage capital. The suggested changes will preserve the traditional source of equity for these cooperatives, and make a rational distinction between classes of retained earnings of investor-owned firms and cooperatives. (Cooperatives do not have retained earnings in the same sense as investor-owned corporations because margins (revenues in excess of costs) are allocated to patrons. Some part may be paid currently; the remainder is used as equity capital pending payout at a later time. Importantly, the change requested by the cooperatives will protect the interest of patron-ratepayers in reasonable rates, and will protect competitors' interest in prohibiting unfair subsidies.

Background

Wisconsin Act 496 of 1993 failed to make any distinction for telecommunications cooperatives with respect to their patronage capital. Most cooperative tax and other authorities use "margin", "patronage capital", "capital credits", "hold-back", "per unit retains", "allocated reserve" and other similar terms almost interchangeably with "retained" income or earnings of the cooperative. However this letter will show that underlying economic theory of "operation on a cooperative basis", under federal tax law, imposes strict limitations on the use of "members' equity".

In the letter order, the PSC-W directed telecommunication cooperatives to classify patronage capital in Account 4520 as "Additional Paid-In Capital". The effect is to treat allocated patronage capital of cooperatives as permanent paid-in-capital, which it is not. In fact to consider it paid-in-capital would contradict the basic principles of cooperatives,

in that the cooperative has an obligation to return the "allocated"¹ patronage to the patrons.

In response, the cooperatives have requested the creation of two new USOA sub-accounts for "retained earnings" which would apply only to cooperatives.

Legislation, Rule or Accounting System Change

In 2001-02, the cooperatives lobbied to amend Chapter 196 with respect to the treatment of retained earnings under s.196.204 (1), Stats. This effort became entangled with "deregulation" efforts, and the legislation failed to pass. The instant case is much narrower, was not the subject of legislation, and cannot wait for a legislative "fix" to cure the effects of Mr. Albino's letter.

The commission can accomplish the change required by the cooperatives through administrative means - a change in the Uniform System of Accounts to accommodate the conventional practice by cooperatives to use allocated "margins" in continued operation of the cooperative. As a change in the USOA, the requested change does not constitute a rule under Chapter 227.01(s).

Why The USOA Classification of Patronage Capital As "Paid-In Capital" Is Inappropriate for Cooperatives

The letter order of the commission would force telephone cooperatives to keep a second set of books to satisfy the PSC requirements. As discussed in more detail below, RUS rules and documents require accounting for patronage capital in account 32.4550, and doing otherwise would raise audit questions. Accounting for patronage capital as "paid-in capital" would also pose a serious risk of loss of cooperative status under IRS rules. Those rules (detailed below) require the return of capital to the member/patron as one of the central features of operation on a cooperative basis. Therefore, the cooperatives would have no choice but to maintain a second set of books - certainly an unreasonable requirement.

A short excursion into tax law and cooperative economic theory is necessary to illustrate why certain cooperative accounting practices are critical and should not be altered by PSC decree. The IRS code, the tax court and many complex opinions and rulings which

¹ "Allocation" is a legal concept central to this discussion, and to the impact of the PSC letter order. As a legal concept, allocation includes distributions of cash, merchandise, issuance of patronage certificates or other instruments, letters of advice or in any other manner of disclosure to a patron the dollar amount apportioned on the books of the association for the account of the patron. (Paraphrasing 26 C.F.R. Part 1, Sec.1.522-b(b)(3)). The language was historically interpreted to require actual notice to each patron, but the IRS has subsequently written that actual notice may not be necessary, but as long as the cooperative's records permit the determination, at any time, each member's rights and interest in annual savings and assets acquired with such savings. Also see Rev. Rul. 72-36, 1972-1 C.B. 151.

flow from tax law form the basis for co-op accounting practices. (Similarly, tax law sets most of the legal boundaries for partnerships, limited liability companies and other pass-through business organizations.) Tax law prescribes accounting practices that will meet certain required cooperative tax principles when operating on a cooperative basis. Rev. Rul. 78-238, 1978-2 CB 161. "Three guiding principles" of cooperative economic theory include (1) subordination of capital, (2) democratic control by the members, and (3) proportional allocation of margins on the basis of patronage. BNA Tax Management Portfolio 229-2nd, Taxation of Cooperatives, p. A-3, (1999). (See Attachment 4.)

Through a number of alternative means, every cooperative must allocate (i.e., place in the members' names for later payout) margins *pro rata* to the members/patrons from whom it was derived in order to preserve tax exempt status and avoid double taxation of the income. Rev. Rul 72-36, 1972-1 C.B. 151. (Attachment 5.) Simultaneously the cooperative must capitalize its operations with members' equity. To skip the unworkable burden of literally paying out, then re-collecting capital from members, state statutes (See. 185.45, Wis. Stats.) prescribe methods to using some or all margins for a period of years, with actual payout ("revolvement") when the co-op's finances permit the refund of the patronage capital. The Commission's order will interfere with these legally prescribed procedures. Puget Sound Plywood, Inc., 44 T.C. 305, 322 (1965). (Also see Discussion section below.)

1. The accounting treatment ordered by the commission does not fit the cooperative business model. Re-classification of allocated (but "retained") patronage refunds as additional paid-in capital (per the PSC letter order) causes members to further capitalize the cooperative on a permanent basis and give up the right to their patronage refunds at the end of the cooperative's established revolvement cycle. Cooperatives may lose their special Cooperative status for income tax purposes by treating retained allocated margins as additional paid-in capital. *Id.* at 305, 323. Also see REA Bulletin 402-3. (Attachment 2.)
2. The capital in account 4520 is reserved for the utility and its operations and expansion, not necessarily the diversified activities where the capital is desired by the members to further serve the members. In other words, the cooperative utility recovers all its normal operating expenses through its rates, so additional capital is not needed there. Instead, the members, through their elected boards, may decide to develop diversified activities to serve the members. Rev. Rul, 72-36. Patronage capital, classified as "retained earnings", is the only source of member equity for these purposes, yet the PSC proposes to reclassify these funds and block their use. For that reason, Account 4520 - Additional Paid-In Capital, is inappropriate.
3. The RUS imposes guidelines on utilities that borrow federal funds in order to assure repayment of federal loans. The PSC order alters the financial structure of the cooperatives for purposes of federal accounting, and jeopardizes the good standing of the cooperative with the RUS. Example, the annual RUS Financial and Statistical Report,

Form 479, filed with RUS, requires that Patronage Capital be recorded in Account 32.4550. (See instructions re retained earnings.) Example: the RUS Mortgage and Security Agreement (which is the lending contract with telephone cooperative borrowers) requires that the account 32.4550 be used to report the equity of nonprofit organizations. (Art II, s. 15 of the agreement.) Example: RUS auditors review the rates and finances, including debt-equity ratio, and status of patrons' accounts - all central to the financial structure and tax status of the cooperative.

4. The RUS (formerly the Rural Electrification Administration, with essentially identical rules for telephone cooperatives) has issued REA Bulletin 402-3 as guidance to borrowers on the proper policy for capital credits. The recommended bylaw contained in the bulletin, includes the following: "All such amounts [allocated capital credits] credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital." RUS (formerly REA) Bulletin 402-3 (1964) Appendix A at 8.²

5. The ordered reclassification of funds has a second effect that was the focus in Chibardun. The measure of retained earnings under the limitation of s.196.204(1) ("Except for retained earnings, a telecommunications utility may not subsidize....") limits cross-subsidization by the regulated entity. Reclassification will limit, if not eliminate, the retains of the telephone cooperatives for purposes of section .204.

6. The PSC order contravenes Chapter 185, Wis. Stats., the IRS Code, RUS guidance and loan documents, and long-standing cooperative accounting conventions.

Discussion

We understand that some telecommunications cooperatives have enacted a bylaw which seems to treat patronage capital as if paid to the patron, then immediately deemed to be furnished by the member to the cooperative as "corresponding amounts for capital" to the cooperative. This form of bylaw does not transform allocated reserves to "paid-in capital" in the view of the Rural Utilities Service (RUS), or IRS. (See below.) Indeed, the RUS has recommended this form of bylaw for telephone cooperatives for the furnishing and retirement of capital. REA Bulletin 402-3.

This bylaw is intended to comply with the requirement for a "pre-existing legal obligation" to return or allocate margins. Farmers Cooperative Co., 33 T.C. 266, (1959). The cooperative's bylaw constitutes the "pre-existing legal obligation" to refund or allocate margins to patrons in order to exclude margins from taxable income. Another primary legal obligation to refund or allocate margins is plainly stated in Chapter 185.45,

² The language cited was not the subject of the bulletin, but the bulletin is illuminating. Due to a lack of time we have been unable to trace the origin of the quoted language.

Wis. Stats. Land O' Lakes, Inc. v. U.S., 470 F.Supp. 238 (D.C. Minn., 1979). Under that section, in para. (3), a cooperative shall distribute "net" income to patrons under two alternate methods. Each method permits the hold back of proceeds, and the payout of the remainder to patrons. Under the second method (para. (4), if the bylaws provide, any of the net proceeds may be "credited to allocated or unallocated surplus or reserves," and the remainder shall be paid to patrons.

This treatment mirrors the design of federal tax law: allocate margins to members as income to the patron, take the deduction in the current year, "retain" and use the allocated equity for the cooperative's purposes - subject to future pay-out to members on a pro-rata patronage basis. (The taxpayer reports the capital credits when received as income in a later year.) The allocation of margins distinguishes a cooperative from that of a corporation in that shareholders of a corporation share in income to the extent of their shares and patrons of a cooperative share in income to the extent of their purchases from the cooperative. This allocation process provides the "record" of the obligation to the patron similar to a preferred stock dividend that is cumulative is an obligation to a corporation. Rev. Rul. 72-36.

The PSC Order Is Unfair To Cooperatives Alone

The PSC-ordered accounting revision has the effect of singling-out cooperatives, and depriving them of equity capital. By labeling allocated patronage capital as "additional paid-in capital", the funds are restricted to use by the utility. Non-utility purposes of telecommunications cooperatives would not have access to their members' equity - again contravening fundamental cooperative principles. This dissimilar treatment of cooperatives places them at a competitive disadvantage in Wisconsin in serving their own members. The commission order would restrict expansion and modernization of rural services by the very firm that is in the best position to serve rural patrons - the firm which patrons have capitalized and belong, the firm which gives its patrons a direct voice in operation and governance of their enterprise.

Unlike investor-owned firms that can issue additional stock, or pay less in dividends to boost retained earnings, cooperatives have no other ready source of equity capital for use in diversification. (The issuance of stock by the cooperative is legally possible, but may place the co-op in a dramatically different legal, tax and economic position than it has chosen.)

More Background: An Explanation of "Patronage Capital" And Its Use by the Cooperative

Patronage refunds might be paid to members from margins earned in the current year, but normally refunds are based on patronage in a prior year (i.e., the first year in the revolvment cycle.) The years between allocation of margins and eventual payout are called the "revolvment period". Every co-op would like to minimize the revolvment

cycle in order to reward members for their patronage as soon as possible, but in many cases it takes many years.³ The IRS prohibits the "improper accumulation of retained funds, but the funds retained can be used for meeting current losses and expenses, retiring indebtedness, acquiring assets, expanding the services of the organization and maintaining reasonable reserves. Rev. Rul. 72-36.

Many factors influence the co-op's ability to pay refunds to members: the relative profitability of the co-op, the level of margins above "operation at cost", the level of competition in reducing sales and or prices, weather (in fuel or electric sales, for example), or broader economic conditions (the farm economy, for example.) It cannot be overlooked that cooperatives were frequently created in places and circumstances where investor-owned firms would not venture due to high risk or low profit. This is certainly true for utility cooperatives: it is the very reason why tax laws accommodate "not-for-profit" firms, and why federal low-interest loans are available for firms in rural areas.

The best illustration of the foundation of a cooperative, especially telecommunications and electric cooperatives in Wisconsin, is to consider their history. When first created in the 1930's and 1940's, Wisconsin's rural residents simply could not obtain utility services from investor-owned firms, nor could they obtain conventional loans to capitalize costly infrastructure. Rural people raised some capital with cooperative membership fees, and leveraged this funding with low interest loans from a sympathetic federal government. The membership fees were not an investment in a distant enterprise - membership and subsequent patronage literally purchased an ownership interest in the cooperative. Inherent in the law of cooperatives is that membership fee and sales revenue from member-patrons will continue to finance the firm. Today this may seem to be a poor "investment". In earlier days, the members were creating their own economic infrastructure and sources of new products and services where none existed. And when it could (in a good year), the co-op would "retire" and pay out capital credits from its earlier years of operations. When a patron dies, his/her right to capital credits will continue to be paid, either in a lump sum (often at net present value) or in annual increments to the heirs or estate. (Again, within legal limits. See Rev. Rul 72-36, and REA Bulletin 402-3.) This financial foundation of cooperatives has its limitations today, when consumer

³ See the RUS Bulletin 402-3 for some discussion of this. Every cooperative determines its own period of revolvment, set by the Board of Directors within legal limits, to serve capital needs. Ideally, the period of revolvment is eight or fewer years, and we believe several Wisconsin telecommunications cooperatives use eight years. However, many cooperatives have a 20-year revolvment of members' capital, and some may never have paid a patronage refund because of unprofitability. Fundamental to understanding the cooperative form of business is the fact that member's equity capital IS NOT an investment as we may think of it in today's economy. Member/equity capital is the member's ownership share of the cost to create and operate the cooperative on an ongoing basis.

expectations are changing. However, in many areas of Wisconsin and the United States, cooperatives operating "at cost" remain as the only willing provider of affordable high quality services to rural people.

The Effect on Ratepayers and Competitors

The statutes grant ratepayers of the telecommunication cooperative their rights to have both a direct voice (annual meeting, special meetings, voting directly or by mail, and otherwise) and a representative voice (board of directors) in the operation of their utility. s.185.12, .13, .31, .32, Stats. In addition, Chapter 196 also protects their interests. Therefore it is difficult to argue that members/ratepayers of the cooperatives are not well-served by the activities of their cooperative in both its utility and non-utility activities. Attendance at meetings of these cooperatives presents every member the opportunity to voice dissent over operations, diversification, and any other activity of the cooperative.

Chapter 196 also protects competitors from unfair competition. Some competitors may argue that the requested clarification would "tilt the playing field" to the advantage of cooperatives. This argument has no merit: as described above, telecommunications cooperatives are hobbled by the current one-size-fits-all treatment of "retained earnings." The limitation in s.196.204 simply fails to recognize that cooperatives have no retained earnings - all revenues ("margins") that exceed costs are assigned to members and are eventually paid out to members in accord with other law. (It is this fact which necessitates the revised accounting order which the cooperatives have requested.)

Firms which protest that cooperatives enjoy unfair advantages are welcome to operate on the same cooperative, "at cost" basis. They never opt to do so because they normally serve areas more densely populated than the regions served by cooperatives.

What the Telephone Cooperatives Have Proposed

The telecommunications cooperatives, all members of WFC, have submitted letters proposing creation of two new subcategories of Account s.32.4550, and a new account for member's equity. To accomplish these changes in accord with the authorities cited above, the telephone cooperatives have proposed creation of:

- sub-account 32.4550.1 Retained Earnings - Patronage Capital Unassigned
- sub-account 32.4550.2 Retained Earnings - Patronage Capital Assigned
- creation of a new Account 32.4511 - Members Equity

Account 32.4550 for "retained earnings" is retained for "patronage capital" because there is no other account to classify it logically. Creation of sub-accounts will assure continued compliance with RUS and IRS requirements.

Patronage capital of cooperatives must continue to be classified as retained earnings for the purpose of the measurement under s. 196.204 (1), where the level of retained earnings are the limit of permitted subsidies of non-utility activities.

The cooperatives have provided the details of how these accounts will meet PSC objectives, while permitting them to continue to operate in compliance with all legal authorities.

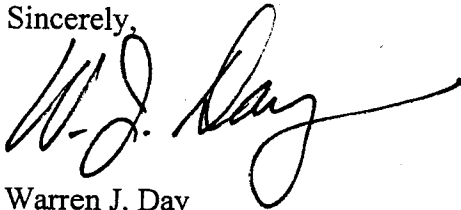
Conclusion

The telephone cooperatives have adopted accounting customs based on rules of the RUS and the IRS, the federal laws which created cooperatives and sanction "operation on a cooperative basis," including all the complexity which that phrase represents. The PSC should accommodate the longstanding accounting and tax conventions, manifest in the varied bylaws of the cooperatives, by creating two sub-accounts for the classification of retained earnings of cooperatives. Doing so would keep PSC rules in harmony with overriding federal tax law, RUS requirements, and state law (Ch. 185). It would be unreasonable to order cooperatives to adopt new bylaws to accommodate the PSC's interpretation of cooperative accounting. It would also be unreasonable to force the cooperatives to keep a second set of books for PSC purposes, as would be necessary to comply with federal requirements.

WFC requests that the PSC act under its authority to administer a uniform system of accounts (Docket 05-US-102) and adopt the changes requested by the telephone cooperatives.

Thank you for your consideration.

Sincerely,



Warren J. Day
Attorney, Wisconsin Federation of Cooperatives

Attachments

CC K. Klingbeil, PSC
M Varda, PSC
All Telephone Co-op General Managers



Public Service Commission

Ave M. Bie, Chairperson
Joseph P. Mettner, Commissioner
Robert M. Garvin, Commissioner

610 North Whitney Way
P.O. Box 7854
Madison, WI 53707-7854

December 17, 2001

TO: Wisconsin Incumbent Local Exchange Telecommunications
Cooperatives

Reply Required

Re: Accounting Treatment for Patronage Capital by
Telecommunications Cooperatives

File TELACCTG

In its order dated November 16, 2001, in *Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc., of its Subsidiaries and of Possible Related Violations*, docket 1090-TI-100, the Commission concluded that Chibardun Telephone Cooperative, Inc.'s patronage capital is not part of account 4550, Retained Earnings, within the meaning of Wis. Stat. § 196.204(1), but rather should be classified in account 4520, Additional Paid-in Capital, based on the distributed nature of patronage capital under that cooperative's bylaws.

By order dated October 1, 1987, in docket 05-US-102, *In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities*, the Commission adopted the following language for subsection (a) of account 4550, effective January 1, 1988:

(a) This account shall include the undistributed balance of retained earnings derived from the operations of the company and from all other transactions not includable in the other accounts appropriate for inclusion of stockholders' equity.

In effect, the Commission's order in docket 1090-TI-100 clarifies that patronage capital does not qualify as an "other transaction" includable in retained earnings under subsection (a) of account 4550.

The above accounting treatment should be implemented by all incumbent local exchange telecommunications cooperatives in Wisconsin. At the present time, the following telecommunications cooperatives are operating in the state:

1. Chequamegon Telephone Cooperative, Inc.
2. Chibardun Telephone Cooperative, Inc.
3. Citizens Telephone Cooperative, Inc.
4. Cochrane Cooperative Telephone Co.
5. LaValle Telephone Cooperative, Inc.
6. Marquette-Adams Telephone Cooperative, Inc.
7. Nelson Telephone Cooperative
8. Richland-Grant Telephone Cooperative, Inc.
9. Tri-County Telephone Cooperative, Inc.
10. Vernon Telephone Cooperative
11. West Wisconsin Telcom. Coop. Inc.

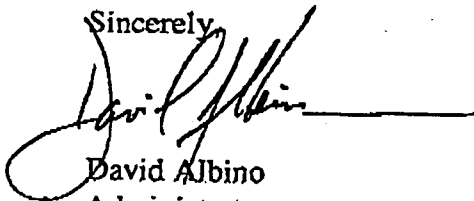
Wisconsin Incumbent Local Exchange Telecommunications Cooperatives
File TELACCTG
Page 2

Consistent with the Commission's finding in docket 1090-TI-100, each cooperative should reclassify its patronage capital to account 4520, Additional Paid-in Capital, by December 31, 2001, and reflect such classification in its 2001 incumbent local exchange carrier annual report to be filed with the Commission on or before April 1, 2002. The reclassification is consistent with Wis. Stat. § 185.45(3), stating that "[u]nless the articles or bylaws otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative but all thereof shall be distributed and paid to patrons, whether members or not." A cooperative's articles or bylaws may provide, however, that any of the net proceeds be credited to allocated or unallocated surplus or reserves of the cooperative, in which case such net proceeds would not be considered patronage capital. See Wis. Stat. § 185.45(4)(a).

Please confirm by letter that this change is being made. If a cooperative believes that all or a portion of its patronage capital does not qualify for classification in account 4520, that entity shall inform the Commission of the particulars constituting alternate classification prior to the closing of that entity's books for calendar year 2001.

If you have any questions concerning the above-specified accounting treatment for patronage capital by telecommunications cooperatives, please contact Kevin Klingbeil at (608) 267-9504.

Sincerely,



David Albino
Administrator
Telecommunications Division

DA:KEK-ang-t-ss letter patronage cap acctg ltr 1201

cc: Ray Riordan, Executive Vice President, Wisconsin State Telecommunications Association, Inc. (WSTA)
Gerald A. Ringlund, Chairman, WSTA Accounting Committee

UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration

March 5, 1964

TO : Boards of Directors of Electric and Telephone Cooperatives

SUBJECT: Capital Credits and Related Consumer Benefits

REA has made important changes in its capital credit recommendations. We believe these merit the careful attention of your cooperative. These changes have been developed with the excellent help and cooperation of representatives from NRECA and NTCA. The basic objective behind these changes is to encourage active support and participation of member patrons in the affairs of the cooperative and to provide them with maximum benefits from its operation. These changes are set forth in detail in a revised REA Bulletin. A summary of these changes and the reasons why they are being made follows.

The unique position of electric and telephone cooperatives in the field of utility service is inescapably dependent upon their inherent characteristics as consumer-owned, nonprofit organizations. Their rightful claim to exemption from the usual pattern of utility regulation is based essentially on the fact that the consumer, the owner and the equity investor are one and the same, and consequently there are not the usual third party rights that require protection by regulatory agencies. Their income tax treatment is based on the fact of cooperative, nonprofit, operation.

It is important to preserve, within reasonable administrative limits, the essential identity of consumer, owner and equity investor. The revolving of capital on a systematic first in, first out basis provides an equitable method whereby each patron furnishes for a period of time his fair share of the capital needed by the cooperative and then has it returned to him as new capital is supplied in subsequent years. This results in a very desirable situation in that to the maximum possible extent the capital will be owned by the current member-patrons who are primarily concerned with the operations of the cooperative. Their active support and participation are of vital importance to the continued success of the cooperative as a member-owned and controlled enterprise.

Clear recognition of the nature of capital credits, including actual retirement as it is deemed proper, is also a critical factor in maintaining the essential position of the cooperative as a nonprofit organization.

The bylaws of a number of cooperatives provide that no retirements shall be made if after the retirement the capital would be below 40 percent of total assets. In view of the comprehensive financial planning by cooperative

borrowers, this bylaw net worth provision is considered unnecessary and may be in conflict with their current objectives. REA therefore recommends the elimination of the net worth restriction on retirements from the capital credit bylaw. A number of borrowers have already eliminated this provision.

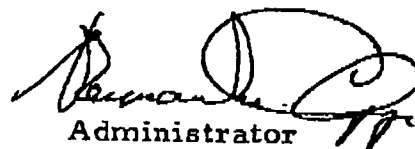
The amount and timing of capital retirements should be determined by each board on the basis of the cooperative's overall financial plan, developed as recommended in REA Bulletins on financial planning. (REA Bulletin 105-4 dated May 12, 1960, is cancelled and a revision will be issued shortly.) By using the financial plan, the board can ascertain what retirements of capital are consistent with the current objectives of the cooperative, including those relating to working capital, reserve funds, rates, and net worth.

The revised bylaw provides that the so-called non-operating margins not needed for offsetting deficits will be included with the amounts furnished as capital and allocated to the patrons. The allocation of non-operating margins in this manner increases the patrons' capital credits, reduces their cost of service, and clearly establishes the interest of each patron in the cooperative's net worth.

The offsetting of deficits or losses against non-operating margins is recommended in order to avoid the carrying of deficits indefinitely on a cooperative's books. Up to this time any deficits incurred, usually during the early years of operation, have remained on the books as a separate item notwithstanding the accumulation of net worth in later years. The revised bulletin now provides an orderly method for offsetting deficits. These offsets will not affect the cash position or change the net worth of the cooperative.

The attached REA Bulletin 102-1 (Electric) and 402-3 (Telephone) and the accompanying capital credit bylaw provisions were submitted to the Internal Revenue Service. It has advised that "the information and recommendations set forth in the Bulletin and the proposed bylaw provisions do not appear to be in conflict with the position of the Service as based on applicable provisions of the Internal Revenue Code and Regulations."

In our judgment these capital credit recommendations provide a sound basic relationship between your cooperative and its member-patrons concerning the furnishing and retirement of capital. They deserve careful consideration by your cooperative. REA personnel will be glad to meet and discuss with your Board any aspects of the new bulletin and bylaw on which you desire more information.


Administrator

UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration

March 5, 1964
Supersedes 8/28/59*

REA BULLETIN 102-1 (Electric)
REA BULLETIN 402-3 (Telephone)

SUBJECT: Capital Credits - Consumer Benefits

- I. Purpose: To set forth recommendations for electric and telephone cooperative borrowers concerning capital credits and related consumer benefits.

II. General:

- A. The Rural Electrification Administration and its cooperative borrowers have a special concern that the cooperatives operate on a non-profit basis and provide maximum benefits for their consumers. Non-profit operation also facilitates the furnishing of area-wide dependable service at the lowest possible cost in keeping with the objectives of the Rural Electrification Act.
- B. Effective bylaws, policies and practices concerning capital credits are essential in providing maximum consumer benefits and in encouraging active member participation in a cooperative's affairs.
- C. Borrowers are responsible for informing REA of changes in bylaws, policies or practices concerning capital credits, including proposed general retirements of capital or other cash distributions to patrons. (See REA Bulletin 100-2: 403-3)

III. Policy and Recommendations:

- A. REA recommends that each cooperative borrower operate under capital credit bylaws whereby all amounts received in excess of losses, costs and expenses will be included in the patrons' capital credit accounts. The bylaws should clearly establish an agreement between the cooperative and its members and patrons that:
 - 1. amounts paid in excess of costs and expenses of providing service are furnished as capital;
 - 2. such amounts will be determined annually on a patronage basis and credited to a capital account for each patron;

*REA Bulletin 102-1

3. all other amounts received by the cooperative from its operations in excess of costs and expenses will be (a) used to offset any losses incurred during the current or any prior fiscal year and (b) to the extent not needed for that purpose, allocated on a patronage basis and included as a part of the capital credited to the accounts of patrons;
 4. each patron will be notified annually of the amounts credited to his capital account; and
 5. capital credited to patrons will be returned to them on a revolving basis when the board determines that the financial condition of the cooperative will not be impaired thereby.
- B. The amount and timing of capital credit retirements should be consistent with REA mortgage requirements and the cooperative's overall financial plan developed as recommended in REA Bulletins on financial planning. Particular attention should be given to such matters as working capital, reserve funds, rates, financing capital additions, and net worth.
- C. Members and patrons should be given full information concerning capital credits to further their understanding and support of the cooperative.
- D. The attached material includes appropriate bylaw provisions and additional information concerning the recommendations set forth above.


Administrator

Attachment
Appendix A

Index

CAPITAL CREDITS:

Consumer Benefits

MARGINS AND CAPITAL:

Capital Credits

APPENDIX A
CAPITAL CREDITS

TABLE OF CONTENTS

	<u>Page</u>
Purpose.....	1
Capital Credit Retirements.....	1
Deficits and Non-Operating Margins.....	3
Allocation of Credits to Patrons' Capital Accounts...	4
Generation and Transmission Cooperatives.....	5
Estates of Deceased Patrons.....	5
Patrons Who Discontinue Service.....	5
Income Tax Treatment of Electric and Telephone Cooperatives.....	6
Income Tax Status of Capital Credits to Patrons.....	7
Information to Patrons on Capital Credits and Notification of Capital Credited to Their Accounts.	7
Recommended Capital Credit Bylaw Provisions.....	8

Purpose: The appendix provides information and guidance to cooperative borrowers concerning capital credits and related consumer benefits as recommended in REA Bulletin 102-1: 402-3. It includes:

1. A discussion of REA recommendations for establishing effective capital credit bylaws, policies and practices to assure non-profit operation and provide maximum benefit to consumers, and
2. A recommended capital credit bylaw provision.

Capital Credit Retirements: Capital credits should be returned to patrons on a revolving basis as soon as it is determined that the overall financial condition of a cooperative permits. Capital credit retirements on a systematic, continuing plan are basic to good cooperative functioning. Revolving the capital of a cooperative -- retiring the older capital as new capital is supplied -- encourages more active support and participation in the cooperative's affairs by present members. This revolving process means that to the maximum possible extent the capital will be owned by the current member-patrons who are vitally interested in the operations of the cooperative. Retirements of capital credits constitute tangible evidence to members and patrons that their cooperative is being operated on a non-profit basis and for their maximum benefit.

The bylaws of a number of cooperatives provide that no retirements shall be made if after the retirement the capital would be below 40 percent of total assets. In view of the comprehensive financial planning by cooperative borrowers, this bylaw net worth provision is considered unnecessary and may be in conflict with their current objectives. REA therefore recommends the elimination of the net worth restriction on retirements from the capital credit bylaw. A number of borrowers have already eliminated this provision.

The determination by the board as to the amount and timing of capital credit retirements should be made on the basis of the cooperative's overall financial plan developed as recommended in REA Bulletins on financial planning. Particular attention should be given to such matters as working capital, reserve funds, rates, financing capital additions, and net worth. The board thus determines that any retirements of capital credits will not impair the financial condition of the cooperative.

REA recommends that retirements of capital credits be made on a revolving basis. The board may retire all or any portion of the credits for a particular year but the oldest outstanding credits would be retired first and thereafter succeeding years' credits would be paid off in order.

The "first-in, first-out" principle for retiring capital credits is recommended because it provides a systematic and equitable method for revolving capital. There may be unusual circumstances where a cooperative may want to consider a modification of the "first-in, first-out" principle. In such isolated instances, borrowers are cautioned to have a thorough legal analysis made in order to determine the extent of possible interference with any vested rights of consumers. Where a cooperative, after such an analysis, finds there are compelling reasons to modify the revolving basis in order that all current patrons may participate in the return of capital credits, the last sentence of the 3d paragraph of Section 2 of the "Non-Profit Operation" article of the by-laws might be changed to read as follows:

"Any such retirements of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the cooperative being first retired, provided, however, that beginning with the year_____, cash made available for retirement in any year may be used to retire capital furnished by all patrons during the most recent fiscal year subject to the requirement that at least fifty per centum (50%) of such cash shall be applied to the retirement of the oldest outstanding capital credits as hereinabove provided."

Retirements of capital by a cooperative borrower are subject to REA mortgage requirements. It is important, therefore, that each cooperative borrower determine that any proposed retirement is consistent with applicable mortgage provisions.

If a cooperative has not always operated under capital credits, a determination of the rights of members and patrons under pre-existing bylaws should also be considered. The disposition of margins and the rights, if any, of members and patrons in margins would normally be governed by

the provisions of the bylaws in effect at the time the margins were received. Some cooperatives, at the time they adopted capital credits, took appropriate corporate action to assign and credit existing margins on an equitable basis to their members and patrons, and elected to treat such margins as patronage capital subject to the same rights and limitations as patronage capital furnished under the new capital credit bylaw. An analysis of any such corporate actions or former bylaw provisions would seem advisable before authorizing general retirements for a particular year or years.

Deficits and Non-Operating Margins: Under capital credits, amounts paid by patrons in excess of costs and expenses of providing service are paid in as capital and are credited to the capital accounts of the patrons. Patrons' capital accounts are credited with the amounts of capital paid in each year even though deficits have been incurred during past years. The bulletin (paragraph III A 3) recommends that all other amounts received by the cooperative from its operations in excess of costs and expenses, usually referred to as 'non-operating margins,' be allocated to patrons on a patronage basis to the extent that such non-operating margins are not needed to offset any losses incurred during the current or prior years.

Before any allocations of non-operating margins are made, losses should be deducted from these margins. This will enable the cooperative to (a) offset deficits in an orderly manner, and (b) account on a patronage basis to its patrons for all amounts received from its operations in excess of costs and expenses. This means that any deficits will be systematically offset by non-operating margins and the patrons will always be credited with the capital they furnish the cooperative together with other allocable amounts. This furthers the objective of providing patrons with maximum benefits from the overall operation of the cooperative.

Non-operating margins arise principally from interest on Government bonds and savings accounts in banks and building and loan associations. Since a cooperative needs to maintain adequate funds for working capital and reserves for the conduct of the business, such as are recommended by REA in Bulletin 1-7: 300-5, it is only reasonable and in the best interests of both the cooperative and its patrons that an interest return on the funds be obtained until such time as the funds are actually used. Inasmuch as these activities are a normal part of operations and are merely incidental to the primary purpose of furnishing electric or telephone service, it is desirable to assign such amounts to patrons' capital accounts on a patronage basis. This increases the consumer benefits from the overall operations of the cooperative.

There may also be other miscellaneous amounts received by the cooperative which may not be classified in the accounts as non-operating margins. To the extent that there is a practical and equitable basis for allocation, it is contemplated that these amounts will be credited to the patrons'

capital credit accounts. For example, gains on sales of property would be included in the amounts to be allocated. Contributions in aid of construction, forfeited membership fees, and gains on acquired capital credits would not be included.

Since most cooperatives have not been allocating non-operating margins to patrons, and past operating deficits have not been offset, any accumulated non-operating margins should be applied against any accumulated deficits. This would not affect the cash position or change the total net worth of the cooperative. If a balance of non-operating margins remains after this offset, the board should decide whether such balance should be allocated to patrons retroactively or remain unallocated. The amount of the balance involved and administrative costs are among the factors to be considered in making this decision.

Cooperatives sometimes engage in minor merchandising activities as a part of power use programs. Any losses from merchandising are borne by the patrons from the cooperative's total operations. Margins resulting from such merchandising activities should generally be included with other so-called non-operating margins to be assigned on a patronage basis. Except where a borrower engages in substantial merchandising activities, and accounts for them separately, there is no need for a specific bylaw provision relating to "Patronage Refunds in Connection with Furnishing Other Services" (Section 3 of the Non-Profit Operation article of the by-laws.)

Allocation of Credits to Patrons' Capital Accounts: The bulletin (Paragraph III A 1 and 2) recommends that the amounts to be credited to the capital account of each patron be determined on a patronage basis. The term "patron" means both member and non-member. No patron should be asked by contract or otherwise to waive his capital credits.

While operating and non-operating amounts are discussed separately in this Appendix, it should be recognized that, as a practical matter, all amounts -- regardless of source -- to be allocated to patrons would be added together and only one allocation would be made annually to each patron. The cooperative, however, should maintain separate records of the annual operating and non-operating margins.

The calculation of credits should be based on the total dollar volume of business done with the cooperative, or on a fair and reasonable variation of this method where it will be more equitable to the consumers. For example, some electric cooperatives provide for deducting from each consumer's annual power bill the direct cost of the kwh purchased by him, and for allocating the capital and other allocable amounts among the consumers on the basis of, and only in proportion to, the remaining balance of the payments for power. Such a method is simply one approach - and, seemingly, a fair and equitable approach -

to the problem of allocating to each consumer his proportionate part of one of the items of cost before arriving at the balance available for capital credits. This and any other method which seeks to break down any of the elements of cost on an equitable and reasonably determinable basis would appear to be proper.

Where service is being rendered to various groups of consumers (such as industrials and commercials) under different rate structures and possibly under different cost of service conditions, it may be appropriate in some cases, that in the determination of the amounts of capital, if any, furnished by such consumers, different approaches or factors be used for these different groups of consumers. To conform to the principle of non-profit operation, such determinations must be reasonably supportable by differences in the cost of service to and the rates paid by such consumers and be reasonably designed to ascertain as accurately as possible the amounts paid by the consumers in excess of the cost of service to those consumers.

Generation and Transmission Cooperatives: Generally, the handling of capital credits for either type of electric cooperative - G&T or distribution - would be the same. Capital credited to the account of a distribution cooperative by a G&T cooperative is an investment by the distribution cooperative in the capital of the G&T cooperative. This capital investment is made initially as a part of the payment for power purchased. While this payment is not broken down for reporting purposes by the distribution cooperative, the capital portion of the payment is, in effect, a reduction in the cost of power which would increase the amount available as capital credits to the distribution cooperative's consumers. The distribution cooperative should allocate to its patrons the capital credits assigned to it by the G&T cooperative at the same time it allocates other capital. In this way, allocation and retirement of capital credits arising from G&T operations will be treated by the distribution cooperative in the same manner and as part of any other capital credits allocated to its patrons.

Estates of Deceased Patrons: Capital credits of deceased patrons may be retired to facilitate the settlement of estates. Under the bylaws, settlements of this type are discretionary with the board so long as they are made under a policy of general application. Some boards have applied a discount because the retirements are made out of turn although many boards have found it more desirable to make such retirements on a 100 percent basis. The financial condition of the cooperative and the expected number of requests of this nature over the years are important factors to consider in establishing a general policy. REA Bulletins 102-2 and 402-2 waive the mortgage provision requiring certain amounts and kinds of assets as a prerequisite to retirements of capital credits of deceased patrons under specified conditions.

Patrons Who Discontinue Service: REA recommends that patrons who discontinue service should not be given a preference on capital credit retirements over other patrons who continue to take service, either by way of

immediate cash refunds or by applying capital credits against unpaid bills. Such a patron is not entitled by the termination of his service to an immediate capital credit refund. His credits normally would be paid off only at the time the cooperative is making a general retirement of credits for a particular year, either by cash or by offset against any unpaid bills. In the meantime his record is held as an inactive account. If a patron cannot be located through his last known address when a general retirement is made, his capital credit record should be retained, and the cooperative can continue using the capital until it is called for by the rightful claimant. If a patron terminates his service, he may under the bylaws assign his capital credits to his successor in interest or occupancy.

Income Tax Treatment of Electric and Telephone Cooperatives: The Federal income tax law has long contained language exempting certain non-profit organizations and cooperatives from the tax and these exemption provisions have been continued, although rewritten and modified in certain respects over the years. Section 501(c)(12) of the Internal Revenue Code of 1954* is the provision generally held applicable to electric and telephone cooperatives.

It provides exemption for:

"Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses."

Telephone cooperatives are specifically mentioned and electric cooperatives are considered "like organizations" within the meaning of this language. Under applicable income tax regulations, tax exemption is not automatic and is recognized by the Internal Revenue Service only after a cooperative has filed an application therefor with the appropriate District Director of Internal Revenue. An organization that is authorized to pay or pays dividends on its stock or membership fees as distinguished from patronage refunds or capital credits would not be eligible for exemption under Section 501(c)(12) according to the position taken by the Internal Revenue Service.

*The Revenue Act of 1962, insofar as it affects the tax treatment of cooperatives and their patrons, does not apply to either (a) electric or telephone cooperatives exempt under Section 501(c)(12), or (b) presently taxable cooperatives which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. (Sec. 1381(a)(2)(A) and (C), Internal Revenue Code of 1954, as amended by the Revenue Act of 1962) Electric and telephone cooperatives and their patrons are, of course, still governed by the previously applicable law.

Most electric and telephone cooperatives have qualified for exemption under Section 501(c)(12) and exemption, once established, would continue in effect from year to year as long as the cooperative meets the requirements for exemption under this Section.* As an exempt organization, however, annual information returns (Form 990) are required. The information return calls for a report on changes in a cooperative's articles of incorporation or bylaws, or any change in its method of operation in order that the effect, if any, of such changes upon the exempt status of the organization may be determined. Compliance with articles and bylaws upon which exemption was granted is, of course, always essential.

While as indicated above only one allocation would be made annually to each patron, care should be taken to insure that the cooperative's accounts will separately reflect the amounts of all operating and non-operating margins. Such segregation of these respective items on the cooperative's books may not be significant so long as it remains exempt from Federal income tax. However, if a cooperative does not have exempt status or has lost it after having been exempt for a period of years, only the amount of the allocations attributable to the operating margin would be deductible in computing the cooperative's taxable income.

Income Tax Status of Capital Credits to Patrons: For the patron of an electric or telephone cooperative who uses service for only non-business purposes, capital credits would in no way enter into his Federal income tax calculations. They merely have the effect of reducing the cost of the electricity or telephone service purchased for personal, living or family use. A patron of an electric or telephone cooperative who deducts all or a portion of his electric or telephone bill as a business expense may, however, have his individual Federal income tax liability affected. The cash received by such a patron, when his capital credits are retired, should normally be reported as ordinary income in the year received but only in the same proportion that payments for service had previously been deducted as business expenses. Patrons may have tax questions of an individual nature and these should be taken up by the patron with the Internal Revenue Director for his district.

Information to Patrons on Capital Credits and Notification of Capital Credited to Their Accounts: REA recommends that members and patrons be given full information concerning capital credits. This is essential to good cooperative relations with members and patrons and to their better understanding and support of the cooperative. It is equally important that members and patrons be notified promptly of the amount of capital

*An electric cooperative in Tennessee has, as a result of a decision of the U.S. Circuit Court of Appeals in U.S. v. Pickwick Electric Membership Corporation, 158 F. (2d) 272 (C.A. 6th, 1946), been held exempt under Section 101 (8) of the Internal Revenue Code of 1939 (Section 501(c)(4) of the 1954 Code) as an organization "for the promotion of social welfare." The Internal Revenue Service, however, does not agree with this decision. Revenue Ruling 57-494, 1957-2 C.B., 315.

credited to their accounts each year. As capital is returned to patrons, the cooperative not only should explain the payments to the patrons but also should acquaint the local community of its action and why the payments are being made. Information concerning each of these activities enables the members, patrons and the entire community to have a better understanding of the non-profit character of the cooperative and of the fact that it is locally owned and operated to provide maximum benefits to its consumers.

Recommended Capital Credit Bylaw Provisions: The attached bylaw provision entitled "Non-Profit Operation" incorporates REA recommendations set forth in Bulletin 102-1: 402-3 and discussed in the Appendix A. To effect these recommendations, the capital credit bylaw provision which many cooperatives have adopted would require amendment. The changes are indicated as follows:

1. Recommended additions are shown in italics and marked by the word "Addition" in the margin.
2. Recommended deletions are shown by a line drawn through the words to be deleted and are marked by the word "Deletion" in the margin.

In addition to this provision, other portions of a cooperative's bylaws may deal with capital credits. These other provisions also help in clearly establishing the contractual relationship between the cooperative and its members. For example, the provision obligating each member to purchase service from the cooperative, and to pay therefor monthly at rates to be determined from time to time by the board should also provide that it is expressly understood that amounts paid by members in excess of the cost of service are furnished by members as capital and each member shall be credited with the capital so furnished as provided in the bylaws. The provision in some of the older electric cooperative bylaws to the effect that "termination of membership shall operate as a release of all right, title and interest of the member in the property or assets of the cooperative" must be deleted since, under capital credits, a former member would not lose the right to any capital credited to his account while taking service merely upon termination of his membership. He may cease to be a member with voting rights but he would not forfeit his capital credits. In addition to the bylaws, there may be instances in which a cooperative's articles of incorporation include some or all of the provisions discussed above depending upon the requirements of the incorporation statute.

Cooperatives which have not yet adopted capital credits should amend their bylaws to include the attached "Non-Profit Operation" provision. The words shown in italics should, of course, be included and the words marked for "Deletion" omitted. Provisions of their bylaws dealing with the disposition of revenues and receipts should be repealed since the new language would replace these provisions and establish the basic contract between the cooperative and its members. In addition, other amendments of the bylaws may be necessary as indicated above. Appropriate revisions of articles of incorporation may also be necessary.

ARTICLE _____

"NON-PROFIT OPERATION"

SECTION 1. Interest or Dividends on Capital Prohibited. The Cooperative shall at all times be operated on a cooperative non-profit basis for the mutual benefit of its patrons. No interest or dividends shall be paid or payable by the Cooperative on any capital furnished by its patrons.

SECTION 2. Patronage Capital in Connection with Furnishing Electric Energy.* In the furnishing of electric energy* the Cooperative's operations shall be so conducted that all patrons will through their patronage furnish capital for the Cooperative. In order to induce patronage and to assure that the Cooperative will operate on a non-profit basis the Cooperative is obligated to account on a patronage basis to all its patrons for all amounts received and receivable from the furnishing of electric energy* in excess of operating costs and expenses properly chargeable against the furnishing of electric energy.* All such amounts in excess of operating costs and expenses at the moment of receipt by the Cooperative are received with the understanding that they are furnished by the patrons as capital. The Cooperative is obligated to pay by credits to a capital account for each patron all such amounts in excess of operating costs and expenses. The books and records of the Cooperative shall be set up and kept in such a manner that at the end of each fiscal year the amount of capital, if any, so furnished by each patron is clearly reflected and credited in an appropriate record to the capital account of each patron, and the Cooperative shall within a reasonable time after the close of the fiscal year notify each patron of the amount of capital so credited to his account. All such amounts credited to the capital account of any patron shall have the same status as though they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital.

Addition All other amounts received by the Cooperative from its operations in excess of costs and expenses shall, insofar as permitted by law, be (a) used to offset any losses incurred during the current or any prior fiscal year and (b) to the extent not needed for that purpose, allocated to its patrons on a patronage basis and any amount so allocated shall be included as a part of the capital credited to the accounts of patrons, as herein provided.

In the event of dissolution or liquidation of the Cooperative, after all outstanding indebtedness of the Cooperative shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payments are made on account of property rights of members. If, at any time prior to dissolution or liquidation, the board of directors shall determine that the financial condition of the Cooperative will not be impaired thereby, the capital then credited to patrons' accounts may be

*For telephone cooperatives, the words "electric energy" should be changed to read "telephone service."

Deletion

retired in full or in part. Any such retirements of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the Cooperative being first retired. In no event, however, ~~may any such capital be retired unless, after the proposed retirement, the capital of the Cooperative shall equal at least forty per centum (40%) of the total assets of the Cooperative.~~

Capital credited to the account of each patron shall be assignable only on the books of the Cooperative pursuant to written instructions from the assignor, and only to successors in interest or successors in occupancy in all or a part of such patron's premises served by the Cooperative unless the board of directors, acting under policies of general application, shall determine otherwise.

Notwithstanding any other provision of these bylaws, the board of directors, at its discretion, shall have the power at any time upon the death of any patron, if the legal representatives of his estate shall request in writing that the capital credited to any such patron be retired prior to the time such capital would otherwise be retired under the provisions of these bylaws, to retire capital credited to any such patron immediately upon such terms and conditions as the board of directors, acting under policies of general application, and the legal representatives of such patron's estate shall agree upon; provided, however, that the financial condition of the Cooperative will not be impaired thereby.

The patrons of the Cooperative, by dealing with the Cooperative, acknowledge that the terms and provisions of the articles of incorporation and bylaws shall constitute and be a contract between the Cooperative and each patron, and both the Cooperative and the patrons are bound by such contract, as fully as though each patron had individually signed a separate instrument containing such terms and provisions. The provisions of this article of the bylaws shall be called to the attention of each patron of the Cooperative by posting in a conspicuous place in the Cooperative's office.

Deletion

~~SECTION 3. Patronage Refunds in Connection with Furnishing Other Services. In the event that the Cooperative should engage in the business of furnishing goods or services other than electric energy, all amounts received and receivable therefrom which are in excess of costs and expenses properly chargeable against the furnishing of such goods or services shall insofar as permitted by law, be prorated annually on a patronage basis and returned to those patrons from whom such amounts were obtained."~~

umns, opposite each name, the number of the contract, the date of the filing, and a brief description of the products, goods or services covered by such contract.

(3) The recording constitutes notice to all persons of the association's rights under the contract. The recording also constitutes such notice that an interest in the title to all products agreed to be sold by the member-maker of such contract to the association during the term of such contract is vested in the association. In case of a purchase of any such product thereafter by any party other than the association from any party other than the association, no interest of any nature shall pass to such other purchaser; the association may recover the possession of such products from any person in whose possession they may be found, may obtain an injunction to prevent any attempted purchase, receipt or transfer not permitted by the contract or may enforce its rights in any manner permitted by law.

(4) The recording constitutes notice to all persons that the contract is and remains a valid contract until:

- (a) It expires according to its terms; or
- (b) It is canceled by written mutual agreement of the parties thereto; or
- (c) It is annulled or otherwise terminated by final judgment of a court.

(5) Whenever the contract has been terminated in any such manner, the association shall give, upon demand, a statement of termination to the member-maker of the contract. Such member may record such statement in the office of the register of deeds where the contract was originally filed or recorded. At least once each year the association shall record in the office of the register of deeds where the contract was originally filed or recorded, a sworn list of the names of all member-makers whose contract has been terminated in any manner specified by sub. (4) (b) and (c). For any recording under this subsection the register of deeds shall receive the fee specified under s. 59.43 (2) (ag).

History: 1981 c. 245; 1985 a. 30 s. 42; 1993 a. 301; 1995 a. 201, 225.

185.43 Relief against breach or threatened breach.

(1) In the event of a breach or threatened breach of a contract authorized by s. 185.41 by a member, the association shall be entitled to an injunction to prevent the breach or any further breach thereof, and to a decree of specific performance. Upon filing of a verified complaint showing such breach or threatened breach, and upon filing a sufficient bond, the association shall be entitled to a temporary restraining order against the member.

(2) Any person, with actual or constructive notice that a contract exists, who induces or attempts to induce any member to breach or repudiate the member's contract with the association, or who in any manner aids a breach of such contract, is liable to the aggrieved party for damages caused by such interference. The association is also entitled to an injunction to prevent any interference or further interference with the contract.

History: 1993 a. 482.

It is not necessary to have demonstrated intent to induce a cooperative member to breach or repudiate his contract with his association, because injury is presumed from violation of the statute. *Pure Milk Products Coop. v. NFO*, 64 Wis. 2d 241, 219 N.W.2d 564.

185.44 Application of ss. 185.41 to 185.43; venue of action. (1) Sections 185.41 to 185.43 apply after July 13, 1955 to all contracts whether made before or after that date.

(2) The proper place of trial of any action by or against an association when based on ss. 185.41 to 185.43 is in the county where the association has its principal office or registered agent.

185.45 Apportionment and distribution of proceeds.

At least once annually the directors shall determine and distribute net proceeds as follows:

- (1) There shall be deducted from total proceeds:
 - (a) All operating expenses and costs.

(b) The cost of supplies, commodities, equipment and other property or services procured or sold for patrons.

(c) The cost of services performed for patrons.

(d) All taxes and all other expenses.

(e) Reasonable and necessary reserves for depreciation, depletion and obsolescence of physical property, doubtful accounts and other valuation reserves, all of which shall be established in accordance with usual and customary accounting practices.

(2) The remainder of the total proceeds are net proceeds and shall be distributed and paid as follows:

(a) An amount not to exceed 5 per cent thereof may be set aside as an educational fund to be used in teaching or promoting cooperative organization or principles. Such funds shall for all purposes except the computation of net proceeds be deemed an expense of operation of the cooperative.

(b) A share of the net proceeds may be set aside for or paid to officers or employees, or both. Such amount shall for all purposes except the computation of net proceeds be deemed an expense of operation of the cooperative.

(c) In a cooperative organized with capital stock such dividend may be paid upon capital stock as is authorized by the articles. No dividend may be paid if the capital is impaired or if payment of such dividend would result in an impairment of capital.

(3) Unless the articles or bylaws otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative but all thereof shall be distributed and paid to patrons, whether members or not, as follows:

(a) Reasonable reserves for necessary purposes may be created, which shall be credited to patrons in accordance with the ratio which their patronage bears to total patronage.

(b) All the remainder of the net proceeds shall be distributed and paid to patrons in accordance with the ratio which their patronage bears to total patronage.

(c) There shall be no distinction between the persons entitled thereto, but such reserves and distributions may be based upon business done with particular departments or in particular commodities, supplies or services, or upon classification of business according to the type or nature thereof.

(4) If the articles or bylaws so provide:

(a) Any of the net proceeds may be credited to allocated or unallocated surplus or reserves of the cooperative.

(b) None of the remainder shall constitute income to the cooperative, but all of it shall be distributed and paid in accordance with the ratio which individual patronage bears to total patronage, either to member patrons only, to member patrons only with one or more classes receiving a lower proportion than others or to all patrons with nonmembers receiving a lower proportion than members, as the bylaws provide. There shall be no other distinction between members and nonmembers, but distribution may be based on business done with particular departments, or in particular commodities, supplies or services, or upon classification of business according to type or nature.

(5) The distribution and payment of net proceeds under sub. (3) or (4) may be in cash, credits, stock, certificates of interest, revolving fund certificates, letters of advice, or other certificates or securities of the cooperative or of other associations, limited liability companies or corporations, in other property, or in any combination thereof.

(6) All or any part of the net proceeds may be applied to losses incurred in prior years, and the bylaws may also include any reasonable provisions for the apportionment of losses.

History: 1985 a. 30 ss. 23, 42; 1993 a. 112.

In action to enforce security interest in certificates of deposit, in absence of article or bylaw provision crediting net proceeds to surplus or reserves, proceeds from cooperative business in excess of actual expenses and compensation of employees belongs to patrons, not cooperative. *Barron 1st Nat. Bk. v. Barron Co. Coop. DCBSA*, 77 Wis. 2d 1, 252 N.W.2d 57.

TAX MANAGEMENT

Taxation of Cooperatives

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TABLE OF CONTENTS

	PAGE		PAGE
DETAILED ANALYSIS			
I. Introduction	A-1	C. Benefits of Exemption	A-16
A. The Cooperative Concept	A-1	1. Deduction of Distributions Paid From Government or Nonpatronage-Sourced Income	A-16
1. Patronage Ownership	A-2	2. Deduction of Dividends Paid on Capital Stock	A-17
2. Patronage Dividends	A-2	3. Other Benefits of Exemption	A-17
B. Scope of Coverage of Portfolio	A-2	III. Subchapter T — All Cooperatives (Exempt and Nonexempt)	A-18
C. Cooperative Tax Principles	A-2	A. Overview	A-18
1. Tax Treatment of Cooperatives Before 1962	A-2	B. Deductions From Gross Income	A-19
2. The Statutory Scheme	A-3	1. Patronage Dividends	A-19
a. In General	A-3	a. Tracing Patronage	A-21
b. "Operating on a Cooperative Basis"	A-3	(1) Tracing to the Appropriate Year	A-21
(1) Generally	A-3	(2) Inventory Adjustments	A-22
(2) Percentage of Member Business Required	A-4	(3) Tracing Patronage From a Federated Cooperative	A-22
(3) Conducting Business With Members	A-5	(4) Tracing Gain on the Sale of a Capital Asset	A-23
(4) Member Participation in Management	A-5	(5) Assignment of Patronage Dividends	A-23
3. Filing Requirements	A-5	b. "Patronage-Sourced Income"	A-23
D. Nature and Type of Cooperatives	A-5	(1) In General	A-23
E. Terminology	A-7	(2) Interest	A-24
1. Margins	A-7	(3) Dividends	A-25
2. Income	A-7	(4) Damages and Settlement Payments	A-25
3. Earnings	A-7	(5) Asset Sales	A-25
4. Patron	A-7	(6) Commodity Credit Corporation Transactions	A-26
5. Patronage Refund	A-7	(7) Miscellaneous	A-26
II. Exempt Cooperatives	A-7	(8) Cooperatives as Members of Partnerships or Limited Liability Companies	A-28
A. Tax and Information Returns for Exempt Cooperatives	A-7	c. Consent for Patronage Dividends	A-29
B. General Requirements for Exemption	A-8	(1) Consent in Writing	A-29
1. Farmers', Fruit Growers' or Like Associations	A-9	(2) Consent by Membership	A-30
2. Organized and Operated on a Cooperative Basis	A-9	(3) Consent by "Qualified Check"	A-31
3. Requirements for Organizations Having Capital Stock	A-10	d. Payment Periods	A-31
a. Dividends Not Greater Than Eight Percent	A-10	2. Per-Unit Retains	A-32
b. Voting Stock Owned by "Producers"	A-10	a. Per-Unit Retain Certificates	A-32
4. Reasonable Reserves	A-12	b. Consent for Per-Unit Retain Certificates	A-32
5. Business With Nonmembers	A-13	3. Amounts Paid to Redeem Nonqualified Written Notices of Allocation and Nonqualified Per-Unit Retain Certificates	A-33
a. Marketing Cooperatives	A-13	4. Additional Deductions for Exempt Cooperatives	A-33
(1) Emergency Purchases	A-13	IV. Special Problems in Cooperative Taxation	A-33
(2) Sideline Purchases	A-13	A. Overlapping Payment Periods — Timing Problems	A-33
(3) Ingredient Purchases	A-14		
(4) Other Incidental Activities	A-14		
b. Purchasing Cooperatives	A-14		
6. Equal Treatment of Members and Nonmembers	A-15		
7. Recordkeeping and Separate Departments	A-16		

B. Operating Losses	A-34	4. Subsidiaries and One Member Cooperatives	A-50
1. In General	A-34	5. Patronage Distributions to Subsidiary	A-50
2. Net Operating Losses	A-34	6. Loss Upon Termination of Subsidiary	A-50
a. Application of §172	A-34	F. Deferred Payment Contracts	A-50
b. Application of §277	A-35		
c. Netting of Losses	A-37	V. Miscellaneous	A-51
(1) Netting Between Departments Within a Function	A-38	A. Formation of a Cooperative	A-51
(2) Netting Between Different Functions	A-38	1. Achieving a Tax-free Exchange	A-51
(3) Offset — Nonpatronage Losses Against Patronage Gains	A-39	a. Requirements for Tax-free Exchange	A-51
(4) Netting Patronage Losses with Nonpatronage Gain	A-40	b. Basis of Stock Received	A-52
(5) Inter-Cooperative Netting	A-40	c. Effect of Tax-free Exchange on the Cooperative	A-52
(6) IRS Approved Methods for Dealing With Losses	A-40	2. Midstream Incorporation Considerations	A-52
C. Accounting for Pools	A-42	a. Assignment of Income	A-52
1. No Pooling	A-42	b. Reallocation of Tax Items	A-52
2. Pooling	A-42	c. Tax Benefit Challenge	A-52
3. Inventory Problems — "Net Realizable Value"	A-43	d. Lack of Business Purpose	A-52
4. Depreciation	A-44	3. Cooperatives and Corporate Farming Laws	A-52
5. Change in Accounting Methods	A-44	B. Redemption or Cancellation of Patron's Stock or Equity	A-53
D. Cooperatives and Reorganizations	A-45	1. Tax Consequences to the Cooperative	A-54
1. Introduction	A-45	2. Tax Consequences to the Patron	A-55
2. Mergers and Consolidations	A-45	C. Articles and Bylaws	A-56
3. Recapitalizations	A-46	1. Discounting Patronage Credits	A-56
a. Exchange of Capital Stock for Credits	A-46	2. Losses — Exempt Cooperatives	A-56
b. Exchange of Revolving Fund Credits for Permanent Capital Fund Shares	A-46	3. Losses — Nonexempt Cooperatives	A-56
c. Exchange of Certificates for Stock	A-46	4. Dissolution	A-57
4. Changes in Organizational Form	A-47	5. Accelerated Depreciation	A-57
a. Converting from a Business Corporation to a Cooperative	A-47	6. Nonqualified Written Notices of Allocation	A-57
b. Converting from a Cooperative to a Business Corporation	A-47	7. Membership	A-57
c. Converting from a Nonprofit Organization to a Cooperative	A-47	8. Consent Bylaws	A-57
5. Miscellaneous Considerations in Reorganizations	A-47	D. Estates	A-57
E. Cooperatives and Subsidiary Corporations	A-47	E. Charitable Deductions	A-57
1. In General	A-47	F. Foreign Patrons	A-57
2. Subsidiaries of Exempt Cooperatives	A-47	G. Escheat	A-58
a. Exempt Status of Parent	A-47	H. Patronage Distributions — Reporting; Back-up Withholding	A-58
(1) Attribution of Activities	A-47	I. Cooperatives and the Alternative Minimum Tax	A-58
(2) Attribution of Ownership	A-48	J. Cooperatives and the Accumulated Earnings Tax	A-59
(3) For-profit Subsidiaries	A-48	K. "Value-Added" Payments to Cooperative Members and Self-Employment Tax	A-60
b. Exempt Status of Subsidiary	A-49		
3. Subsidiaries of Nonexempt Cooperatives	A-49	WORKING PAPERS	B-1
		BIBLIOGRAPHY	C-1

DETAILED ANALYSIS

I. Introduction

A. The Cooperative Concept

A cooperative is a business entity of a unique form that distributes its income to a particular member in accordance with that member's use of the cooperative. This feature distinguishes a cooperative from the partnership or corporate form of doing business.¹ The primary function of a cooperative is the allocation of economic benefits, either in the form of net savings or net earnings, to the member-patron based on the quantity of business done with the member-patron. For other entity forms, such as corporations or partnerships, economic benefits are allocated based on the amount of investment in or services provided to the organization. Cooperatives, however, resemble other businesses in certain respects. Cooperatives have similar physical facilities, perform similar functions, and must follow sound business practices. Cooperatives usually incorporate under state laws, although state statutes are specifically designed for cooperatives. Cooperatives draw up bylaws and other documents. Members elect a board of directors. Despite these similarities, cooperatives remain different from other businesses with respect to their purpose, ownership, control and distribution of benefits.

Most cooperatives are characterized by democratic ownership and user control, limited returns to capital, return of net income or margins to users on the basis of use, and the obligation of users to provide equity or ownership financing. Democratic control generally means that a member has one vote regardless of the amount of that member's patronage or stock investment. Some states, however, permit voting based upon a member's patronage and stock investment. In those jurisdictions, the power of a single member is usually limited by allowing the member to cast no more than a small percentage of total qualified votes, typically less than three percent.²

Most states have statutory limits specifying the maximum rate of return on investment capital. In many jurisdictions, an eight percent rate is established as the maximum return, but some states establish much higher limits. These statutes are premised upon the general idea that an agricultural cooperative is not designed as a for-profit investment vehicle.

The feature that cooperative profits are distributed in accordance with a particular member's use (also known as

patronage) is consistent with the goal of maximizing members' interests and the notion that the cooperative is an extension of the members' business operations. To accomplish this objective, a cooperative attempts to market patrons' commodities at the highest possible price and purchase quality inputs at the lowest possible cost. The resulting savings (usually referred to as net income rather than profits) belong to the patrons and are distributed to them at least annually, usually in the form of patronage refunds, though not necessarily all in cash. Typically, at least 20% is paid out as a cash patronage refund and the balance is invested in the user's name as a retained patronage refund. The retained portion is redeemed at a later time, usually when the user has stopped using the cooperative.

Generally, but not always, cooperatives are formed under state "cooperative" statutes.³ An organization may be "operating on a cooperative basis" for federal tax purposes even though it is organized under a state business corporation or trade association statute.⁴ The Internal Revenue Code ("Code") does not define "operating on a cooperative basis;" however, administrative and judicial

¹ See, e.g., N.Y. Coop. Corp. Law §110 *et seq.*; Minn. Stat. §308.05 *et seq.*; D.C. Code §29-801 *et seq.*; Tex. Agric. Code §51.001 *et seq.*; Wis. Stat. §185.01 *et seq.*; Cal. Agric. Code §54001 *et seq.*

² §1381. All references herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated. Regulations defining "operating on a cooperative basis" were prepared in draft form in 1974. However, their provisions encompassed such sensitive areas as one person-one vote, netting, and the application of §277 to cooperatives, that they were never released, even as proposed regulations. See 27 *Coop. Accountant* 37 (Spring 1974). In PLR 8937019, the IRS, citing *Puget Sound Plywood, Inc. v. Comr.*, 44 T.C. 305 (1965), *acq.*, 1966-1 C.B. 3, ruled that a corporation was taxable as a cooperative since it adhered to the three basic principles of cooperatives: (1) no dividends paid on capital contributions; (2) patronage distributions based on business done with or for the cooperative; and (3) democratic control. See also PLR 9402012 (survivor of merger of affiliated laundry service and purchasing service for group of hospitals taxed as cooperative because it operated on a cooperative basis under §1381(a)(2)); PLR 9322028 (corporation providing storage and loading services deemed to be operating on a cooperative basis after amending its by-laws to call for subordination of capital, democratic control, and operation at cost); PLR 9313016 (purchasing corporation with democratic control, subordination of capital, and allocation of excess operating revenues considered to be operating on cooperative basis under §1381(a)(2)); PLR 9237013 (changes in base capital plan did not cause wholesale supply cooperative to cease operating on cooperative basis); PLR 9235011 (taxable parent corporation's transfer of business assets to subsidiary in split-off permitted parent to qualify for taxation as purchasing cooperative).

³ An organization operating on a cooperative basis may deduct patronage allocations even though it is organized under a state's business corporation statute. See *Smith & Wiggins Gin, Inc. v. Comr.*, 37 T.C. 861 (1962), *aff'd*, 341 F.2d 341 (5th Cir. 1965); *U.S. v. Mississippi Chemical Co.*, 197 F. Supp. 490 (S.D. Miss. 1961), *aff'd*, 326 F.2d 569 (5th Cir. 1964); *Linton Plywood Ass'n v. U.S.*, 410 F. Supp. 1100 (D. Or. 1976); *Producers Gin Ass'n, A.A.L. v. Comr.*, 33 T.C. 608 (1959), *acq.*, 1960-2 C.B. 6; *Southwest Hardware Co. v. Comr.*, 24 T.C. 75 (1955), *acq.*, 1955-2 C.B. 9; *United Cooperatives, Inc. v. Comr.*, 4 T.C. 93 (1944), *acq.*, 1945 C.B. 6; *Peoples Gin Co., Inc. v. Comr.*, 41 B.T.A. 343 (1940), *aff'd*, 118 F.2d 72 (5th Cir. 1941); *Eugene Fruit Growers Ass'n v. Comr.*, 37 B.T.A. 993 (1938).

¹ While a primary objective of cooperative formation is to provide members with a measure of economic market power, rarely will the business a single cooperative member transacts have a perceptible impact on prices paid for inputs or on prices received upon sale of products produced. Consequently, a cooperative is designed to give its members the benefits of group action in the production and marketing of commodities, and in obtaining supplies and services.

² In some states, the percentage is higher. For example, in Kansas the limit is five percent. See Kan. Stat. Ann. §17-1613 (1996).

interpretations of that phrase are discussed later in this Portfolio.⁶

The two principal criteria for "operating on a cooperative basis" are patron ownership of the entity and patronage dividends.

1. Patronage Ownership

Ownership of the cooperative is vested in the persons who patronize the cooperative, rather than in investor-stockholders. This does not mean that all patrons must have an ownership interest. Many cooperatives do significant amounts of business with persons or entities which do not have an ownership interest (sometimes referred to as "non-member business" or "nonmember patronage").⁷

2. Patronage Dividends

Cooperatives return their earnings only to their patrons (or to their member-patrons), in proportion to their patronage.

While pronouncements have been made by the IRS asserting other criteria for "operating on a cooperative basis," patronage ownership and patronage dividends are central to much litigation and administrative rulings.⁸ Other criteria are discussed later in this Portfolio.⁹

B. Scope of Coverage of Portfolio

This Portfolio examines the application of federal income tax law to cooperatives. The primary Code provisions are §521 (for exempt cooperatives) and §§1381-1388 (Subchapter T). Certain cooperatives or similar entities are specifically excluded by §1381(a)(2)(B) and (C) from the provisions of these sections and are excluded from the coverage of this portfolio. These include cooperative housing corporations,¹⁰ rural electric associations and telephone cooperatives,¹¹ mutual savings banks,¹² and mutual insurance companies.¹³ This Portfolio does not examine state taxation of cooperative associations.¹⁴

C. Cooperative Tax Principles

Cooperatives calculate taxable income and use tax rates just as other corporations do, but with one principal difference related to a cooperative's distinct way of distributing net margins (profits) to its patrons based on use rather than to investors based on investment.

In general, earnings of a cooperative flow through the cooperative to patrons, with the cooperative not retaining any margins as profit. Thus, earnings are taxed only once.

The tax is ultimately paid by the cooperative patron, although under some circumstances, the cooperative pays tax on a temporary basis, then receives a deduction when the money is finally passed on to the patron. The rule of single taxation, however, only applies if business income sources and distribution methods are "cooperative" in nature. Earnings derived from nonpatronage sources and margins not distributed in the manner specified by the Code are generally ineligible for single-level tax treatment.

Upon the satisfaction of certain statutory conditions, cooperatives treat retained patronage refunds and per-unit retains as if the funds retained had been paid to the patron, deducted by the cooperative, accounted for in the patron's income as ordinary income, then invested in the cooperative. Conditions for this tax treatment include agreement by the patrons to recognize the full patronage refund for tax purposes even though not received in cash or negotiable form.

Farmer cooperatives that meet several organizational and operational rules set forth in §521 are allowed to deduct two additional items: (1) dividends paid on capital stock and (2) distributions of nonpatronage earnings to patrons on the basis of their patronage.¹⁵

1. Tax Treatment of Cooperatives Before 1962

While farmer cooperatives existed before the federal income tax, the Revenue Act of 1913 did not mention cooperatives. Tax exemptions for marketing cooperatives (1916)¹⁶ and purchasing cooperatives (1921)¹⁷ were enacted for cooperatives which dealt only with members. By 1926, Congress added requirements limiting dividends for capital stock and restricted reserves of an exempt cooperative.¹⁸ In 1934, Congress allowed business with the United States to be disregarded for purposes of determining whether a cooperative would meet the standards for exemption from federal income tax.¹⁹

Until 1951, farmers' cooperatives which met the exemption rules did not pay tax. In 1951, former §522 was enacted giving "exempt" cooperatives the right to claim certain deductions for dividends on capital stock and patronage distributions from income from sources other than patronage.²⁰ While still termed "exempt," cooperatives were subject to the corporate tax. A cooperative which distributed patronage dividends could deduct them in determining taxable income and the patron would pay the tax on dividends received. A series of court decisions in the mid-1950's, upset the general tax scheme of the Revenue Act of 1951, however. Courts held that patronage refunds "paid in paper" (termed written notices of allocation) had no value and were not taxable income to their recipients.²¹ While the cooperative could still deduct the allocation, no tax was being paid at either the cooperative or the patron

⁶ See I, C, 2, b, below.

⁷ The word "member" has different meanings in different cooperatives. Some cooperatives have no capital stock, and therefore have "members" who may or may not hold "membership certificates." Other cooperatives issue common stock (and also may issue preferred stock), and refer to their shareholders either as "stockholders" or as "members."

⁸ A subsidiary that deals only with its parent (the "patron") is not acting for the mutual benefit of its members and cannot be a cooperative. PLR 8225013 (cooperative cannot have only one patron).

⁹ See I, C, 2, b, below.

¹⁰ §216. See 596 T.M., *Cooperative and Condominium Apartments*.

¹¹ §501(c)(12).

¹² §591.

¹³ §501(c)(15).

¹⁴ Caveat: The reader is cautioned to study carefully the consequences under state law of any proposed transaction.

¹⁵ §§521(b), 1381(a)(1); 1382(c). See II below.

¹⁶ Revenue Act of 1916, §11(11).

¹⁷ Revenue Act of 1921, §11(11).

¹⁸ Revenue Act of 1926, §231(12).

¹⁹ Revenue Act of 1934, §101(12).

²⁰ Revenue Act of 1951, §314.

²¹ See, e.g., *Long Poultry Farms, Inc. v. Comr.*, 27 T.C. 985 (1957), rev'd, 249 F.2d 726 (4th Cir. 1957); *Carpenter v. Comr.*, 20 T.C. 603 (1953), aff'd, 219 F.2d 635 (5th Cir. 1955), acq., 1958-2 C.B. 4; *Caswell's Est. v. Comr.*, 211 F.2d 693 (9th Cir. 1954), rev'g 17 T.C. 1190 (1952).

level. This led to the enactment of Subchapter T (§§1381-1388) and repeal of §522 in 1962. The purpose was to impose a single tax on all earnings of a cooperative, either at the entity or member level.²²

2. The Statutory Scheme

a. In General

Subchapter T of the Code, "cooperatives and their patrons,"²³ is the basis for cooperative taxation and the taxation of patrons.

Part I of Subchapter T consists of three sections. Section 1381 describes cooperative organizations to which Subchapter T applies. Subchapter T applies to all farmer cooperatives, including farmer cooperatives qualifying under §521.²⁴ However, a business need not be a farmer cooperative to qualify for Subchapter T tax status. Any business "operating on a cooperative basis" uses Subchapter T when computing its tax liability.²⁵ Section 1382 describes how cooperatives calculate their taxable income. This provision explains how cooperatives may reduce their gross income by the amount they pay in noncash patronage refunds and per-unit retains. Section 1382 also covers the time period in which patronage and per-unit retains must be paid, special accounting rules for pooling arrangements, and the problem of earnings received after patronage has occurred. Section 1383 describes how a cooperative is to compute taxes in the year it redeems nonqualified written notices of allocation and nonqualified per-unit capital retains. The cooperative makes two alternative calculations described in the section and uses the more favorable of the two.

Part II of Subchapter T consists only of §1385. This section addresses patron taxation. It describes how patrons are to account for patronage refunds and per-unit retains received from a cooperative. Under §1385, patrons are to exclude from gross income patronage refunds properly taken into account as an adjustment in the basis of property, or attributable to personal, living or family items.

Part III of Subchapter T consists of §1388. This section contains an important set of definitions including such key cooperative tax terms as "patronage dividend (refund)," "written notices of allocation," "qualified written notice of allocation," "per-unit retain allocation," and "qualified per-unit retains certificate." Section 1388 also provides rules for obtaining consent from patrons to include noncash allocations in taxable income and for the netting of patronage gains and losses.

Comment: The basic scheme of Subchapter T is deceptively simple, but variations in practices of cooperatives and concepts of the IRS result in a complex, uncertain, and often confusing body of published and private rulings.

b. "Operating on a Cooperative Basis"

(1) Generally

Any corporation operating on a cooperative basis²⁶ may deduct from gross income (in addition to other allowable deductions) all qualified²⁷ patronage dividends²⁸ and per-unit retain allocations.²⁹ Moreover, it may deduct amounts paid in redemption³⁰ of the portions of those items which were previously distributed as nonqualified³¹ written notices of allocation, or as nonqualified per-unit retains.

The fact that the Code provides that "any corporation" can be a cooperative indicates a Congressional intent to accommodate within the scope of Subchapter T the special nuances, regulatory requirements, financial arrangements, and other factors unique to various industries.

The only statutory limits to the benefit of qualifying as a cooperative are found in the definitions of a "patronage refund"³² and "per-unit retain allocation."³³ To be excluded from taxable income, a patronage refund must be paid on the basis of the business each patron conducted with the cooperative, under a pre-existing legal obligation to make the payment, and out of earnings of the cooperative from business with patrons. In addition, refunds must be computed on the same basis for patrons who engaged in substantially identical transactions with the cooperative. Section 1388(f) requires a per-unit retain also to be made pursuant to an agreement between the cooperative and the patron.

In the late 1950s and the early 1960s, the IRS took the position that workers' cooperative associations were not among the classes of cooperatives eligible to exclude patronage refunds from taxable income.³⁴ In 1964, a federal district court held that a workers' cooperative was entitled to exclude retained patronage refunds from gross income to the same extent as purchasing or marketing cooperatives.³⁵ In 1965, the Tax Court also ruled against the IRS by holding that a workers' cooperative was a "cooperative association" for federal income tax purposes.³⁶ The Tax Court listed "three guiding principles" as the core of cooperative economic theory: (1) subordination of capital, (2) democratic control by the members, and (3) proportional allocation of margins on the basis of patronage.³⁷

²² §1381.

²³ §1388.

²⁴ §1382(b). The following statement on deducting patronage dividends appears in *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201, 213 (N.D. Iowa 1949):

"The exclusion of patronage dividends for federal income tax purposes has not been placed upon the ground that cooperatives are special creatures of statute under the tax laws, but is justified rather upon the theory that patronage dividends are in reality rebates on purchases or deferred payments on sales, allocated or distributed pursuant to a pre-existing obligation of the cooperative, and thus do not constitute taxable income to the cooperative."

²⁵ §1382(b).

²⁶ §1388.

²⁷ §1383.

²⁸ §1388(a).

²⁹ §1388(f).

³⁰ The IRS issued a revenue ruling in 1961 expressing its position on this issue. See Rev. Rul. 61-47, 1961-1 C.B. 193, *rev'd* by Rev. Rul. 71-439, 1971-2 C.B. 321.

³¹ *Linton Plywood Ass'n v. U.S.*, 236 F. Supp. 227 (D. Or. 1964).

³² *Puget Sound Plywood, Inc. v. Comr.*, 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

³³ *Id.* at 308.

²² See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 113, 310 (1962).

²³ §§1381-1388.

²⁴ §1381(a).

²⁵ §1381(a)(2). Language in §1381(a)(2) specifically excludes mutual savings banks, insurance companies, and utility cooperatives from the scope of Subchapter T.

In 1982, the IRS issued several technical advice memoranda and private letter rulings³⁸ concerning the issue of whether a cooperative was "operating on a cooperative basis" by evaluating clients on the basis of the list of cooperative principles referred to in the Tax Court's 1965 *Puget Sound* decision.³⁹

Beginning in 1991, the IRS, through additional rulings, added four "additional factors" in determining whether a taxpayer qualified as a cooperative: (i) existence of some joint effort on behalf of the members; (ii) a minimum number of patrons; (iii) member business exceeding non-member business; and (iv) upon liquidation, present and former patrons sharing in the distribution of any remaining assets in proportion to the business each transacted with the cooperative over some reasonable period of years.⁴⁰ In 1993, the IRS issued a revenue ruling relying on the *Puget Sound* decision, stating that "the cooperative principles stated in *Puget Sound* . . . provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of Subchapter T of the Code."⁴¹

In *Puget Sound*,⁴² the Tax Court clearly stated that a cooperative association with certain attributes comes within the scope of "operating on a cooperative basis" under Subchapter T. The IRS appears to be reading that decision to say only cooperatives with those specific traits and certain additional features can be considered as "operating on a cooperative basis." Thus, the IRS' view is that even a cooperative that meets the *Puget Sound* tests still may not be "operating on a cooperative basis" if it does not conform to various additional procedures. However, the Code's only requirement for a single tax treatment of patronage refunds is that the return or allocation of per-unit retains to patrons be on the basis of patronage pursuant to a pre-existing legal obligation.⁴³ Indeed, in *C.F. Industries v. Comr.*,⁴⁴ the court bolstered the view that the obligation to pay patronage refunds is the predominant characteristic of a cooperative. The court stated that the principal difference between the cooperative form of doing business and the corporate form is that the shareholders of a cooperative share in the cooperative's income in proportion to their purchases from the cooperative rather than based upon the number of shares they own.⁴⁵

Comment: The holding in *C.F. Industries* suggests that the IRS' various expressions of cooperative principles and practices should not be read into the Code as additional mandatory restraints on organizations wishing to qualify for Subchapter T tax treatment.

The Tax Court supported this approach in *Ford-Iroquois FS, Inc. v. Comr.*,⁴⁶ where it stated that "the definition is of value as a matter of clarification but should not be used for substantive exclusion or for limitation or analysis."⁴⁷ Similarly, the Tax Court stated that "the operation at cost principle describes a feature of a cooperative's relation with its members, not a codified requirement of tax accounting."⁴⁸ In this case, the IRS was arguing that the general cooperative principle that cooperatives "operate at cost" prevented a cooperative from carrying a loss forward for tax purposes. The Tax Court rejected the IRS' position and permitted the cooperative to carry the losses forward under §172.⁴⁹

(2) Percentage of Member Business Required

The IRS has attempted to place a quantitative requirement into "operating on a cooperative basis." In 1968, the IRS issued a ruling which implied that a cooperative might conduct less than 50% of its business with members.⁵⁰ The ruling included an example of a cooperative that conducted 50% of its business with members and 50% with nonmembers. However, in 1972, the IRS distinguished its 1968 ruling by stating that the example used in the 1968 ruling was not intended to state a rule with respect to the amount of nonmember business a "nonexempt" cooperative may have.⁵¹ As a result, Rev. Rul. 72-602⁵² modified Rev. Rul. 68-728⁵³ to the extent the former implied that a "non-exempt" cooperative which deals with nonmembers at a "profit" could conduct 50% or less of its business with members and still qualify under Subchapter T. However, three different federal courts have rejected the "percentage" rule as a requirement for "operating on a cooperative basis."⁵⁴

In 1985, the Service ruled that, for purposes of the 50% test, a cooperative filing a consolidated corporate return with subsidiaries cannot aggregate the amount of business done by all of the subsidiaries with members.⁵⁵ Each cooperative must still conduct 50% or more of its business with its own members. In 1990, the IRS held that a corporation which estimated that less than 50% of its business would derive from members was operating on a cooperative basis.⁵⁶ Here, the corporation was found to be operating on a cooperative basis where the corporation estimated that more than 50% of the value of its business would be conducted with member and nonmember patrons, but less than 50% of the value of the business would be conducted with members.

³⁸ 74 T.C. 1213 (1980).

³⁹ *Id.* at 1217, note 3.

⁴⁰ *Id.* at 1222.

⁴¹ See also *Associated Milk Producers, Inc. v. Comr.*, 68 T.C. 729, 740 (1977).

⁴² Rev. Rul. 68-228, 1968-1 C.B. 385.

⁴³ Rev. Rul. 72-602, 1972-2 C.B. 510.

⁴⁴ 1972-2 C.B. 510.

⁴⁵ 1968-1 C.B. 385.

⁴⁶ See *Conway County Farmers' Ass'n v. U.S.*, 588 F.2d 592 (8th Cir. 1978), rev'g, 1978-1 USTC ¶9334 (E.D. Ark. 1978); *Columbus Fruit & Vegetable Coop. Ass'n v. U.S.*, 7 Cl. Ct. 561 (1985); *Geauga Landmark v. U.S.*, No. 81-942 (N.D. Ohio 1985). The Claims Court, in *Columbus Fruit*, found the IRS' position so unreasonable that legal fees were awarded to the taxpayer.

⁴⁷ PLR 8530001.

⁴⁸ PLR 9019011.

³⁹ TAM 8219821; TAM 8225013; PLR 8324108; See also PLR 8505001 and TAM 8707005 (substituting "operation at cost" for proportional allocation of margin on basis of patronage); PLR 8744007; PLR 8748015; PLR 8823032; PLR 8842034; PLR 8850027.

⁴⁰ 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

⁴¹ PLR 9117037; TAM 9303004. Only additional factors (ii) and (iii) were considered in PLR 9141028, PLR 9235011, and PLR 9237013. Additional factors (ii), (iii), and (iv) were mentioned in PLR 9313016. While several of the rulings state that these additional factors are considered important by the courts, no citations were provided.

⁴² Rev. Rul. 93-21, 1993-1 C.B. 188.

⁴³ 44 T.C. 305 (1965), *acq.*, 1966-2 C.B. 6.

⁴⁴ §1388.

⁴⁵ 995 F.2d 101 (7th Cir. 1993).

⁴⁶ *Id.*

In 1991, the IRS finally conceded that a corporation may be considered to be operating on a cooperative basis even when it conducts more than 50% in value of its business with nonmembers.⁵⁷ The IRS stated that it would instead use a facts and circumstances test to determine whether an organization is operating on a cooperative basis. Similarly, in Rev. Rul. 93-21,⁵⁸ the IRS ruled that a cooperative that operates on a nonpatronage basis with nonmembers will not be precluded from being considered as "operating on a cooperative basis" simply because it conducts less than 50% in value of its business with members on a patronage basis. However, the IRS still considers the 50% rule to be a factor in determining whether a cooperative is entitled to Subchapter T tax treatment.

Whether these precedents will lead to an eventual determination that the only consideration needed in an "operating on a cooperative basis" inquiry is whether the patronage refunds or per-unit retains meet the definitional requirements of the Code is an issue that will not likely be resolved in the near future.

(3) Conducting Business with Members

As previously noted, a major distinction between a cooperative and other corporations is that a cooperative's business is done with or for its member/shareholders. In a case in which a cement company sought to classify distributions as "patronage dividends," the court found that the payments were actually dividends paid to shareholders with whom the company did not operate on a cooperative basis.⁵⁹ The court characterized the arrangement as a "cooperative camouflage" because the shareholders were not patrons of the cooperative or users of its cement. Instead, the shareholders were investors in a company which sold cement to the general public, and received distributions in the form of dividends on corporate stock.

In Rev. Rul. 82-51,⁶⁰ a poultry cooperative sold newly hatched chicks to its member/shareholders. The chicks were raised by nonmember third parties and repurchased by the cooperative when ready for market. The IRS ruled that because the shareholders were "nonessential links to the outside and not consumers of the corporate product," the cooperative was not operating on a cooperative basis. The IRS noted that the sale of the chicks to the shareholders served no business purpose other than to establish the shareholders as members and that the shareholders did not engage in the active conduct of poultry operations.

In a private letter ruling,⁶¹ a cooperative issued preferred patronage rights to shareholders which gave the shareholders the right to purchase commodities from the cooperative in the same proportion as each patron's stock ownership. The shareholders formed another cooperative and assigned preferred patronage rights to the cooperative which then marketed the commodities purchased from the

first cooperative. The IRS ruled that the second cooperative did not operate on a cooperative basis because the shareholders of the second cooperative did not purchase or produce the commodities marketed by the cooperative.

A rural electric cooperative operating under the Rural Electrification Administration guidelines was ruled to be operating on a cooperative basis when the cooperative charged its member customers "margins" which were credited to each member's capital accounts.⁶² Any excess margins collected during the year were distributed back to the members on the basis of patronage.

(4) Member Participation in Management

Just as it did concerning the limitation on percentage of business, the IRS initially sought, but later abandoned, the one-member, one-vote requirement with respect to qualifying under Subchapter T.⁶³ The statute and regulations do not require operation on a one-person, one-vote basis for qualification as operating on a "cooperative basis."⁶⁴

3. Filing Requirements

A "cooperative" ⁶⁵ has eight and one-half months after the close of the taxable year to file its tax return. This extended filing period is available for §521 cooperatives and other Subchapter T cooperatives with an obligation to pay patronage refunds on at least 50% of their net earnings from business conducted with or for patrons.⁶⁶ Exempt cooperatives must file their tax returns on Form 990-C. All Subchapter T cooperatives must also file annual information returns, on Forms 1096 and 1099, with the IRS, reporting payments of interest, dividends and qualified written notices of allocation (patronage refunds), and redemption of nonqualified written notices of allocation, of \$10 or more a year to any one person.⁶⁷ The cooperative must also include in these annual returns the amount of qualified per-unit retain certificates issued, as well as the amounts paid in redemption of nonqualified certificates of \$10 or more to any one person.⁶⁸

A cooperative is exempt from the above reporting requirements if it is primarily engaged in retail selling of goods and services that are generally for personal, living, or family use, (*i.e.*, nonbusiness use) that would not normally be reportable as income by the recipient.⁶⁹ Application for exemption from the information reporting requirement is made through the local District Director of IRS.⁷⁰

D. Nature and Type of Cooperatives

Cooperatives are voluntary business organizations chartered by state law which enable persons to join together for

⁵⁷ AOD 1991-018, *acq. in result only*, *Conway County Farmers Ass'n v. U.S.*, 588 F.2d 592 (8th Cir. 1978), *rev'g* 1978-1 USTC ¶9334 (E.D. Ark. 1978).

⁵⁸ 1993-1 C.B. 188, *modifying* Rev. Rul. 72-602, 1972-2 C.B. 510.

⁵⁹ *Mississippi Valley Portland Cement Co. v. U.S.*, 408 F.2d 827 (5th Cir. 1969), *aff'g*, 280 F. Supp. 393 (S.D. Miss. 1967).

⁶⁰ 1982-1 C.B. 117.

⁶¹ PLR 8609006.

⁶² PLR 9024054.

⁶³ *Puget Sound Plywood, Inc. v. Comr.*, 44 T.C. 305 (1965), *acq.*, 1966-1 C.B. 3 (discusses origin of cooperative concept and appears to give much emphasis to one-member, one-vote democracy concept). *See also* Rev. Rul. 66-98, 1966-1 C.B. 200 (discussion of doing business on cooperative basis).

⁶⁴ *See* §1381; Regs. §1.1381-1.

⁶⁵ As that term is defined in §6072(d).

⁶⁶ Most business corporations only have two and one-half months after the close of the taxable year to file their tax returns. §6072(b).

⁶⁷ §6044. *See also* Regs. §§1.6042-1(a)(1), 1.6044-3. *See also* Rev. Rul. 68-236, 1968-1 C.B. 382.

⁶⁸ Regs. §1.6044-3.

⁶⁹ §6044(c).

⁷⁰ §6044; Regs. §1.6044-4.

Detailed Analysis

mutual help, joint purchasing, and collective marketing for the benefit of the members.⁷¹ Agricultural cooperatives tend to be either marketing cooperatives or supply cooperatives although some conduct both functions. A marketing cooperative is designed to assist in the marketing of its members' agricultural products. A supply cooperative is designed to secure supplies and equipment needed by the membership at the lowest possible per unit cost. Many local grain cooperatives combine the marketing and supply functions and may provide services such as grain storage and drying, fertilizer application and feed grinding and mixing. There are also service cooperatives, such as rural electric and telephone cooperatives, which provide services that might otherwise be unavailable to rural residents.

The following types of cooperatives are not defined in the Code, but frequently appear in rulings and cases:

- A "local" cooperative is a cooperative whose members are farmers or other persons in the local area served by the cooperative.

- A cooperative having a "federated" structure (often called a "regional" cooperative) is a cooperative whose members include other cooperatives. It usually serves a number of "local" cooperatives, often several hundred.⁷² In these types of cooperatives, patronage refunds simply pass down through the structure. Each cooperative, however, makes its own decision as to how much income to distribute to its patrons, and is generally not obligated to pass all earnings from one level to the next level.

- An "interregional" cooperative (sometimes called a "superregional") is a cooperative whose members include federated cooperatives.

- A "marketing" cooperative either functions as a purchaser of its members' products at the prevailing market rate or as a pooling agency.⁷³ If the cooperative purchases its members' products, the products may then be commingled with some or all of the products offered for resale. At the end of the taxable year, any resulting net earnings are allocated to each patron on the basis of the patron's percentage of business. The patron then receives his or her share of the earnings as a patronage refund.

In a marketing cooperative, members may agree to market their products to the cooperative by the use of marketing contracts. While this practice is seldom used by

grain marketing and farm supply cooperatives throughout the midwest, in other jurisdictions marketing contracts may require the members to sell all or any specified part of their production through the cooperative for a specific period of time, usually not to exceed ten years. In general, exclusive cooperative marketing contracts are valid so long as they conform to the usual requirements of contract law. Generally, the cooperative's obligations under the contract are to sell the product and return the sale price to the member, deducting expenses and other costs as specified in the agreement.

- If the cooperative functions as a "pooling agency," individual farmers or ranchers, as well as farm or ranch corporations, LLCs and partnerships, contract with the cooperative to sell their product at a prescribed price, less an amount for marketing costs based on volume. All of the production for a particular season is then "pooled" and marketed. In this situation, the cooperative does not enjoy net earnings. Participants receive all of the pooled proceeds in accordance with the marketing agreement, less amounts contributed to the capital of the cooperative on a per-unit basis. These amounts are referred to as "per-unit retains." The per-unit retains are held as capital of the cooperative and are redeemed or repurchased in the same manner as deferred patronage allocations. Pooling arrangements are characterized by a sharing of risks, expenses and revenues with payment of an average price. Marketing pools tend to be heavily utilized by milk, fruit, vegetable and nut cooperatives.

- A "bargaining" cooperative bargains collectively for its members by acting as their agent. A bargaining cooperative is similar to a marketing cooperative in that it acts as an intermediary between its members and processors. Bargaining cooperatives generally do not take physical possession of agricultural products. The actual sale of the product may be made by the member to the buyer, but on terms agreed to by the cooperative. This type of marketing cooperative is almost exclusively used by dairy farmers and vegetable producers.

- A "supply" cooperative purchases the products needed by its members, such as machinery parts, fertilizer, feed or petroleum products, at wholesale prices. Large, regional cooperatives may own and operate fertilizer manufacturing plants, feed mills, oil refineries and other production plants. These products are then sold to the members as they need them. Net earnings at the end of the accounting period are distributed to the members as patronage refunds, based upon the volume of business transacted by the member with the cooperative. Some portion of these refunds may be deferred and retained by the cooperative, to be paid to the members at a future date as an equity redemption.

Most local agricultural cooperatives perform both marketing and supply functions and are "buy-sell" organizations. In addition, most agricultural cooperatives are capital stock organizations. Many of the cooperatives that began as nonstock cooperatives, issuing member certificates to their patrons, have now converted to stock cooperative status.

While the majority of cooperatives serve agriculture, any group of individuals or businesses may operate on a cooperative basis and have the benefits of Subchapter T

⁷¹ See I, A, above.

⁷² There are several revenue rulings and revenue procedures regarding how exempt federated cooperatives may maintain their exempt status. Because this is a specialized area, it is not dealt with in this Portfolio. A practitioner interested in exempt federated cooperatives should examine the following: Rev. Rul. 84-81, 1984-1 C.B. 135; Rev. Rul. 73-138, 1973-1 C.B. 293; Rev. Rul. 72-52, 1972-1 C.B. 165; Rev. Rul. 72-51, 1972-1 C.B. 164; Rev. Rul. 72-50, 1972-1 C.B. 163; Rev. Rul. 71-493, 1971-2 C.B. 240; Rev. Rul. 69-651, 1969-2 C.B. 135; Rev. Proc. 73-38, 1973-2 C.B. 501; Rev. Proc. 72-17, 1972-1 C.B. 739; Rev. Proc. 72-16, 1972-1 C.B. 738.

⁷³ Legislation has been proposed to specify that a cooperative that adds value to a farmer's product by feeding the product to animals and selling the animals remains a marketing cooperative. The legislation clarifies that the phrase "marketing the products of members and other producers" includes feeding the products of members and other producers to cattle, hogs, fish, chickens or other animals and selling the animals (or animal products) which were fed such feed products. S. 2498, 105th Cong., 2d Sess. (1998); H.R. 1469, 106th Cong., 1st Sess. (1999), amending §1388 by adding new subsection (k).

(but not of §521), e.g., associations of hardware dealers, grocers, and "workers' cooperatives."⁷⁴

E. Terminology

1. Margins

"Net margins" or "margins" are synonymous with the terms "profit," "net profit," "income," "net savings" and "net income" when referring to money a cooperative earns on business conducted on a cooperative basis. Margins generally correspond to the phrase "net earnings of the organization from business done with or for its patrons" used in the Code.⁷⁵

2. Income

"Income" is sometimes used on a net basis as a synonym for "profit." "Income" may, however, also be used in a gross basis to include all revenue that flows into the cooperative from business operations. "Income" is defined broadly to include cash and checks received to pay for services rendered and products provided. Income also includes interest, rents and dividends received. Funds obtained as loans or equity investments are not considered income for tax purposes.

3. Earnings

The term "earnings" describes what is commonly referred to as "profit," or total income less expenses. This must be distinguished from the more limited term "margins," which are earnings from business operated on a cooperative basis. Cooperatives can, and frequently do, however, conduct some of their operations on a non-cooperative basis.

4. Patron

The term "patron" is not statutorily defined. The regulations, however, provide that "patron" includes any person with whom a cooperative conducts business on a *cooperative basis*, whether a member, nonmember, natural person, corporation, partnership or association.⁷⁶ Those who conduct business with a cooperative on a *noncooperative basis* ("commercial customers") include suppliers to a purchasing cooperative, grain purchasers from a marketing cooperative, and drop-in trade (for example, individuals who buy gasoline from a cooperative gas station on the highway). As indicated in Rev. Rul. 76-388, 1976-2 C.B. 180, patronage status is not attained by selling minor nonproducer items to the cooperative, and patronage dividends need not be paid

to those patrons. The IRS has ruled that manufacturers doing business with a cooperative can be patrons,⁷⁷ but that in the particular case in question, the shareholders of a corporation were not genuine patrons, as they received their share of earnings based on their stock holdings.⁷⁸

5. Patronage Refund

A "patronage refund" consists of net margins from business conducted with or for patrons that are allocated or distributed to patrons on a patronage basis.

Example: Cherry Valley cooperative has a net margin for the year of \$5,000. Sid Smith accounted for five percent of the business conducted on a cooperative basis that year. Sid will receive a patronage refund of \$250 (\$5,000 × .05).

A primary difference between cooperatives and other forms of business is the way earnings are distributed. In a cooperative, the margins are returned to users as patronage refunds, based on the amount of business each user conducts with the cooperative. In a noncooperative business, the earnings are returned to investors as dividends, based on the amount of investment in the company. Thus, a patron's refund is a return based on use, while a dividend is a return based on investment.⁷⁹

II. Exempt Cooperatives

A. Tax and Information Returns for Exempt Cooperatives

An organization attempting to be treated as an exempt farmers' cooperative for tax purposes must file a Treasury Form 1028. Although the regulations provide that Form 1028 should be filed with the District Director for the district where the cooperative's principal place of business or principal office is located, all Form 1028 exemption applications are now handled by the Ohio Key District Office, and Form 1028 must be filed with the IRS Service Center in Covington, Kentucky.⁸⁰ The cooperative may obtain a ruling in advance of conducting its operations, but must furnish information in sufficient detail to enable the District Director to find an actual or proposed compliance with the statutory requirements.⁸¹ Special rules and procedures have been issued relative to the qualification of federated cooperatives.⁸²

⁷⁴ Private letter ruling dated Jan. 23, 1970. See the Working Papers.
⁷⁵ PLR 7929008.

⁷⁶ This distinction is complicated by the Code's use of the term "patronage dividends" in referring to what is generally called "patronage refund." See, e.g., §§1382(b), 1388(a). Technically, a "patronage dividend" (within the meaning of the Code) is a "patronage refund" that meets certain Code requirements, such as being paid pursuant to a pre-existing legal obligation of the cooperative to make the refund. In most instances, "patronage refunds" that do not qualify as "patronage dividends" (for tax purposes) are treated as "dividends" for tax purposes. See, e.g., *Peoples's Gin Co. v. Comr.*, 41 B.T.A. 343 (1940), *aff'd*, 118 F.2d 72 (5th Cir. 1941); *Juneau Dairies, Inc. v. Comr.*, 44 B.T.A. 759 (1941).

⁷⁷ Regs. §1.521-1(a)(3)(C). See Instructions to Forms 1028 and 8718 and Rev. Proc. 98-8, 1998-1 IRB 225.

⁷⁸ Rev. Proc. 80-25, 1980-1 C.B. 667 contains detailed procedures for filing an application for exemption, the standards to be considered by the District Director in making a determination, the procedure for protesting an adverse determination, and the procedures to be followed upon the proposed revocation or modification of an exemption letter.

⁷⁹ Rev. Rul. 69-751, 1969-2 C.B. 135; Rev. Proc. 73-38, 1973-1 C.B. 451; Rev. Proc. 72-16, 1972-1 C.B. 738; Rev. Proc. 72-17, 1972-1 C.B. 739.

⁷⁴ See, e.g., *Astoria Plywood Corp. v. U.S.*, 79-1 USTC ¶9197 (D. Or. 1979); *Linnton Plywood Ass'n v. U.S.*, 410 F. Supp. 1100 (D. Or. 1976); *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949).

⁷⁵ §1388(a)(3). In *Illinois Grain Corporation v. Comr.*, 87 T.C. 435 (1986), the court stated that "profits" and "income" are considered somewhat dirty words in the cooperative fraternity. Consistent with the broad philosophy that cooperatives are intended to operate at cost, eliminating entrepreneurial profit and returning their net earnings to their patrons on an equitable basis, . . . cooperatives tend to eschew the words "profits" and "income," preferring instead the more delicate terms "margins" and "savings."

⁷⁶ Regs. §1.1388-1(e). The major distinction between a member and a patron is that the member has voting rights and the patron does not. Some cooperatives also have nonvoting members. These persons have allocation rights if there are shortages of oil, fertilizer, or similar items. In some states, statutory voting rights are mandated where the cooperative takes action affecting a nonvoting member's stock. See, e.g., Wis. Stat. §185.52.

Revenue Ruling 72-36

Section 501

fice of the organization. See section 1.501(a)-1 of the regulations.

Revenue Ruling 56-65, C.B. 1956-1, 199, is clarified to the extent it may imply that plan room and publication activities of the type described in this ruling are not appropriate activities of a business league exempt under section 501(c)(6) of the Code.

26 CFR 1.501(c)(12)-1: Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

Certain requirements that cooperative companies must meet for exemption under section 501(c)(12) of the Code are explained.

Rev. Rul. 72-36

The Internal Revenue Service has received inquiries from cooperative companies regarding certain requirements for exemption from Federal income tax under section 501(c)(12) of the Internal Revenue Code of 1954.

Section 501(c)(12) of the Code provides for exemption from Federal income tax of mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, if 85 percent or more of their income consist of amounts collected from members for the sole purpose of meeting losses and expenses.

Section 1.501(c)(12)-1(a) of the Income Tax Regulations provides that excess funds on hand at the end of the year may be retained to meet future losses and expenses, or returned to members.

The specific questions and their answers are as follows:

Question 1.

Should the interests of members in the savings of an organization be determined in proportion to their business with the organization?

Answer:

Yes. In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of an organization should

be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.

Question 2.

Can funds be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes?

Answer:

Yes. However, such funds may not be accumulated beyond the reasonable needs of the organization's business. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.

Question 3.

Where an organization retains funds for purposes other than meeting current losses and expenses, must the organization's records show each member's rights and interest in the funds it retains?

Answer:

Yes. To maintain its mutual or cooperative character an organization must keep such records as are necessary to determine, at any time, each member's rights and interest in the assets of the organization.

Question 4.

What is the effect on exemption of a forfeiture of a former member's rights and interest where the bylaws provide for such forfeiture upon withdrawal or termination?

Answer:

If, under the bylaws, a member's rights and interest have been forfeited, the organization has not operated on a mutual or cooperative basis and is therefore not exempt.

Question 5.

Where, upon dissolution, an organization has gains from the sale of an appreciated asset, how should these gains be distributed?

Answer:

Such gains should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.

26 CFR 1.501(c)(13)-1: Cemetery companies.

The exempt status of a cemetery company is not adversely affected if it sells monuments, markers, vaults, and flowers solely for use in the cemetery and uses the sales proceeds for maintenance of the cemetery.

Rev. Rul. 72-17

Advice has been requested whether the status of a cemetery company exempt from Federal income tax under section 501(c)(13) of the Internal Revenue Code of 1954 is adversely affected where it sells monuments, markers, vaults, and flowers in the manner described below.

The organization was formed and is operated for the purpose of providing and maintaining a cemetery. The organization sells cemetery lots, provides burial services, erects monuments, and maintains the cemetery grounds. In addition, it sells monuments, markers, vaults, and flowers solely for use in the cemetery. All profits realized from these sales are used to maintain the cemetery as a whole.

Section 501(c)(13) of the Code provides for the exemption from Federal income tax of cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not

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RECEIVED

July 31, 2002

Ms. Lynda Dorr and
 The Public Service Commission
 7610 N. Whitney Way
 Madison, WI 53702

RECEIVED

JUL 31 2002

TELECOMMUNICATIONS
 DIVISION

Re: TELEACCTG; Docket 05-US-113
 Comment on Resolving the Co-op Patronage Capital Matter for Telephone
 Cooperatives

Dear Ms. Dorr and Commissioners:

The telephone cooperatives urge the Commission to omit cooperative patronage capital accounting from Docket 05-US-113. We further ask the Commission to review the record quickly (if that has not yet occurred) and direct the staff to adopt two sub-accounts of 32.4550 as suggested by the cooperatives for the 2002 fiscal years.

Comments on the Process

1. The delay in resolving this matter has already impeded the business activities of the cooperatives due to regulatory uncertainty. Protracted review in the broad accounting docket, 05-US-113, would only further confuse and delay those matters.
2. Originally, the staff proposed to alter cooperatives' accounting practices by a simple letter order. No public hearing was even considered, and none is required now.
3. A full record has now been placed before the Commission for review. The ripe for Commission decision now.
4. Neither the review of this matter or the accounting compliance docket is the appropriate place to adjudicate compliance with Act 496 provisions (as one competitor has suggested.) The Commission process should not be used by others for anti-competitive purposes, or obfuscation.

On The Merits of the Cooperatives' Accounting Proposal

Creating two subaccounts of account 32.4550 has two purposes. First, placing cooperative retained earnings in two sub-accounts will preserve the cooperatives' tax status, protect member's future patronage refunds and "retain" funds for investment in the future of the cooperative (as the members direct). Second, the

cooperatives offered their proposal in response to Mr. Albino's directive to "inform the commission of the particulars constituting alternate classification". Their proposal is based on solid legal grounds.

1. Re-classification of retained earnings (Account 4550), as additional paid-in capital (Account 4520) puts the co-ops' tax status at risk because the return of patron's retained capital is fundamental to co-operative "operation on a cooperative basis." (Rev. Rul. 72-36, Attachment 5 to June 4, 2002 letter.) There is no known precedent for the reclassification, so the IRS position is unknown. A negative decision by the IRS could have monumental consequences for the cooperatives.

The PSC staff seems riveted by a literal reading of one line in the bylaws which the telephone cooperatives have adopted: "All such amounts credited to the capital account of any patron shall have the same status *as though [or as if]* they had been paid to the patron in cash in pursuance of a legal obligation to do so and the patron had then furnished the Cooperative corresponding amounts for capital." (Emphasis added.)

The meaning and application of this bylaw is fundamental to co-op operation and tax status. The provision (or substantially similar versions) is in use uniformly by telephone and electric cooperatives throughout the United States. Its meaning is complex, rooted in the Internal Revenue Code. 34 Am Jur 20175 (attached) explains the key phrases and concepts.¹ [The initialed comments below correspond to points in the attached excerpt.] Also see 18 Am Jur 2d, s.23, enclosed

- a) The purpose of the bylaw is to enable deduction of the patronage "dividend" paid-out to patrons from the co-op's income.
- b) "[T]he same status as though paid" recognizes that the co-op can "pay" the patronage to the member by giving written notice that the margins have accrued in the member's name (if the bylaw is in place), or by payment of money, a certificate of indebtedness, or other property.
- c) The Internal Revenue Code has recognized in sec. 1388(c); Reg. s.1.1388(c) that the members consent to this method of written notice by virtue of joining a cooperative under its membership agreement.²
- d) The "legal obligation" of the cooperative to pay patronage refunds is established in the co-op's articles or bylaws, and is statutorily required in Wisconsin, too. 185.45, Wis. Stats.

2. We believe it is beyond the PSC's authority to force a regulated firm to act in a manner that would jeopardize its chosen business structure, a structure sanctioned by federal laws, including 26 USCA 501(c)(12), 1381, et. seq.; and Chapter 185, Wis. Stats.)

¹ The section is titled "Farmer' Cooperatives" under IRC 521, but as with so many IRC provisions which apply to cooperatives, the same rules apply to 501(c)(12) cooperatives.

² Section 1381 (often referred to as Subchapter T) specifically does not apply to telephone and electric cooperatives, meaning the prior, pre-1962 statute still applies to them. The essential difference is that telephone and electric cooperatives must meet an income-source test in order to qualify for tax-exempt status. That issue is not relevant here. In most other respects, regulation is identical.

3. For purposes of section 196.204(1), the Commission's proposed reclassification would eliminate "retained earnings" only for cooperatives. Under that statute, retained earnings are the measure (limit) of capital available for investment outside the utility. The change, if imposed only on cooperatives, would discriminate against cooperatives as compared to all other firms covered by the statute. Competitors want to do this.

4. The present system of accounting, modified by the creation of two sub-accounts of retained earnings, will avoid all these legal and political pitfalls.

5. Finally, The PSC staff also asks why account 4520 cannot accommodate patron's capital "as though paid in"? We can only say that the change introduces serious uncertainty over tax status, and puts co-ops at a decided disadvantage, as described above. **We pose a different question: If the retained earnings account isn't suited to co-ops' patronage credits, (because of the language of the Chibardun bylaw) why does the staff believe patronage refunds fit any more appropriately as paid-in capital - given the long history and documented tax and legal basis underlies treatment as retained earnings?**

One staff opinion is that 1993 Wisconsin Act 496 did not intend to accommodate telephone co-op retained earnings, and therefore the Legislature should clarify this accounting problem. We regard this as merely an excuse for PSC inaction. As explained above, co-op and IRS law has recognized co-op-retained earnings for decades. It is no less an administrative "innovation" for the PSC to interpret co-op earnings as paid-in capital than to refine the account used through history.

Requested Action

Having provided very extensive documentation and argument supporting the cooperatives' proposal for two sub-accounts, the Cooperatives now ask for an immediate decision in directing adoption of the sub-accounts of s.4550. We believe the matter can and should be handled informally, as was the staff's original plan when Mr. Albino commenced the review on December 17, 2001. If still more time is needed, please direct the staff to complete its internal review promptly so that the cooperatives can get on with business.

Sincerely,



Warren J. Day
Attorney for Telephone Cooperatives and
Wisconsin Federation of Cooperatives

association and who⁵¹ has paid full value for his certificate has no priority over other certificate holders to the association's remaining assets on dissolution.⁵¹

⁵² The stockholders of a cooperative marketing association are interested in the assets accumulated by such association, including claims acquired by it, and hence the association is without power to cancel any such claim.⁵²

§ 23. Revolving capital fund and equity credits therein

Statutes regulating the structure of cooperative associations, and bylaws of such associations adopted pursuant thereto, frequently provide for the retention by the association of all or a portion of the operating profit of the association in order to furnish capital for the association, and in evidence of this each member of the association is credited with his proportionate part on the books of the association, and is generally issued a certificate showing such credit.⁵³ This plan is known as the revolving fund plan, or equity plan, and the credits are known as equity credits. These credits are in effect the capital of the cooperative, and it has been said that the plan for raising capital in this way is the most equitable means by which a cooperative can acquire its capital from its patrons.⁵⁴

The capital secured through such an equity plan is comparable to the earned surplus of a conventional business organization.⁵⁵

It is well settled that equity credits allocated to a patron on the books of a cooperative do not reflect an indebtedness which is presently due and payable by the cooperative to such patron. Such equity credits represent patronage dividends which the board of directors of a cooperative, acting under statutory authority, has elected to allocate to its patrons, not in cash or other medium of payment, which would immediately take such funds out of the working capital of the cooperative, but in such manner as to provide or retain capital for the cooperative and at the same time reflect the ownership interest of the patron in such retained capital. Equity credits are not an indebtedness of a cooperative which is presently due and payable to the members, but represent an interest which will be paid to them at some unspecified later date to be determined by the board of directors.⁵⁶ Therefore, equity credits cannot be used as a setoff against a member's present indebtedness to the association.⁵⁷

51. Re Kitsap-Mason Dairymen's Asso., 6 Wash App 926, 497 P2d 604.

52. Burley Tobacco Growers' Co-op Ass'n v Tipton, 227 Ky 297, 11 SW2d 119.

53. McCauley v Arkansas Rice Growers' Co-op. Ass'n., 171 Ark 1155, 287 SW 419; Ozona Citrus Growers' Ass'n v McLean, 122 Fla 188, 165 So 625.

Practice Aids.—Provision of articles or by-laws concerning contributions to capital. 5 AM JUR LEGAL FORMS 2d, COOPERATIVE ASSOCIATIONS § 71:85.

—Forms relating to Certificates on indebtedness and capital stock. 5 AM JUR LEGAL FORMS 2d, COOPERATIVE ASSOCIATIONS §§ 71:131-71:138.

54. Bowles v Inland Empire Dairy Asso. (DC Wash) 53 F Supp 210

Practice Aids.—Revolving Fund Certificate. 5 AM JUR LEGAL FORMS 2d, COOPERATIVE ASSOCIATIONS §§ 71:55, 71:56.

55. Clarke County Cooperative v Read, 243 Miss 879, 139 So 2d 639.

56. Clarke County Cooperative v Read, 243 Miss 879, 139 So 2d 639; Schmeckpeper v Panhandle Cooperative Asso., 180 Neb 352, 143 NW2d 113 (final distribution of earnings and savings may be made by payment in cash, stock, stock credits, deferred credit certificates, or certificates of participation as determined by board of directors when by-laws so provide).

Annotation: 50 ALR3d 435, 486-498 §§ 20-26 (time of distribution).

57. Howard v Eatonton Co-operative Feed Co., 226 Ga 788, 177 SE2d 658; Forrest County Cooperative Assn v Manis (Miss) 235

¶ 20175. Cooperatives—Exemption; Patronage and Nonpatronage Distributions.

34 AM JUR 2nd

A cooperative (co-op) or mutual organization generally have the same persons as owners and customers. Co-ops generally are taxed like ordinary business corporations,

but some are tax-exempt. All co-ops are entitled to deduct patronage dividends, and exempt farmers co-ops may also deduct certain nonpatronage distributions.

¶ 20176. How cooperatives (co-ops) are taxed. Although some co-ops are *classified* as exempt (¶ 20177), most, exempt and nonexempt, are taxed the same as any ordinary business corporation, at the regular corporate rates, but with a deduction for patronage dividends (see ¶ 20178).¹

Nonexempt co-ops aren't membership organizations subject to the Code Sec. 277 limits on the aggregation of member losses with nonmember income (see ¶ 16840).²

¶ 20177. Classification as an exempt co-op. An exempt co-op (e.g., a farmers' co-op, see ¶ 20185) is considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.³

observation: Although exempt co-ops are potentially subject to income tax, they're commonly referred to as exempt co-ops due to their classification as exempt organizations.

Co-op Distributions

¶ 20178. Co-op's deduction of patronage dividends and per-unit retain allocations. Patronage dividends (¶ 20179) and per-unit retain allocations (¶ 20180) represent transient amounts the co-op doesn't take into account if it pays them out as described below. This is done by treating a patronage dividend as an item of gross income and as a corresponding deduction from gross income, and by excluding or deducting the per-unit retain allocation from the co-op's income.⁴

Co-ops may exclude or deduct their per-unit retain allocations to the extent the amounts are paid in money, qualified per-unit retain certificates, or other property (except nonqualified per-unit retain certificates) with respect to marketing during the tax year.⁵

To be excludable (deductible), patronage dividends or per-unit retain allocations paid in money or other property (except written notices of allocation or per-unit retain certificates) must be paid by the 15th day of the 9th month after the end of the tax year. Payment may be by qualified check (¶ 20181) paid during this period, if the check is endorsed and cashed on or before the 90th day after the end of the period.⁶

¶ 20179. Patronage dividends defined. Patronage dividends represent distributions of the co-op's net earnings among the cooperators and other patrons, according to each person's patronage or contribution to its net earnings. It's an amount paid to a patron by a co-op: (1)

on the basis or quantity of business done with or for that patron; (2) under a pre-existing valid enforceable written obligation of the co-op to the patron to pay that amount; and (3) determined by reference to the co-op's net earnings from business done with or for its patrons.⁷

A patronage dividend may be paid in money, a certificate of indebtedness, or other property, including a qualified written notice of allocation (¶ 20181).⁸

¶ 20180. Per-unit retain allocation defined. A per-unit retain allocation is an allocation (other than by paying money or other property) by a co-op to a patron with respect to products marketed for him, if the amount is fixed without reference to the co-op's net earnings, under an agreement between the patron and the co-op.⁹

¶ 20181. Qualified written notice of allocation and qualified per-unit retain certificates. A qualified written notice of allocation or qualified per-unit retain allocation is treated as the equivalent of money at its stated dollar amounts.¹⁰

A *written notice of allocation* may be a capital stock or revolving fund certificate, a retain certificate, a certificate of indebtedness, a letter of advice, or any other written notice which discloses the dollar amount allocated to the patron on the co-op's books and the portion that is a patronage dividend.¹¹ For a written notice of allocation to qualify: (1) it must be redeemable in cash at its stated dollar amount at any time within at least 90 days from receipt (the patron must have been advised in writing, of his right of redemption); or (2) if the notice isn't so redeemable, the patron must have consented in writing in advance to include the stated dollar amount in his income (this consent may take the form of endorsement of a qualified check); and he must have received 20% of the distribution within that 90-day period (in cash or qualified check).¹²

A *per-unit retain certificate* is a written notice which discloses the stated dollar amount of the co-op's per-unit retain allocation to the recipient.¹³ A per-unit retain certificate qualifies if the distributee has agreed to take it into account at its stated dollar amount.¹⁴

¶ 20182. How patronage dividends and per-unit retain allocations are taxed to patrons. Patronage dividends (¶ 20179) and per-unit retain allocations (¶ 20180) received in money are included in income by the patron in the year received. Qualified written notices of allocation and qualified per-unit retain certificates (¶ 20181) are included in income at their stated dollar

1. Code Sec. 1381(b); Reg § 1.1381-1(a); Reg § 1.1381-2(a)(1).

2. Landmark Inc v. U.S., (1992, Cl Ct) 69 AFTR 2d 92-495, 25 Cl Ct 100, 92-1 USTC ¶ 50058; Buckeye Countrymark Inc, (1994) 103 TC 547 acq 1997-18 IRB 4.

3. Code Sec. 521(a); Reg § 1.521-1(a)(1); Reg § 1.1381-2(a)(1).

4. Code Sec. 1381(a); Code Sec. 1382(b); Reg § 1.1382-1; Stevenson Co-Ply Inc, (1981) 76 TC 637.

5. Code Sec. 1382(b)(3).

6. Code Sec. 1382(d).

7. Code Sec. 1388(a); Reg § 1.1388-1(a)(1).

8. Code Sec. 1382(b); Salley Inc, James W. v. U.S., (1976, DC LA) 38 AFTR 2d 76-5076, 76-1 USTC ¶ 9443.

9. Code Sec. 1388(f); Rev Rul 68-236, 1968-1 CB 382.

10. Code Sec. 1388(e)(2).

11. Code Sec. 1388(b); Reg § 1.1388-1(b).

12. Code Sec. 1388(c); Reg § 1.1388-1(c).

13. Code Sec. 1388(g).

14. Code Sec. 1388(h).

amount when received, and other property (but not non-qualified allocations or nonqualified per-unit retain certificates) is included at its fair market value when received.¹⁵

But the amount of any patronage dividend isn't included in income to the extent it's properly taken into account as an adjustment to basis of property, or attributable to personal, living, or family items.¹⁶

Patronage dividends don't qualify for the corporate dividends-received deduction (see ¶ 4201 *et seq.*).¹⁷

¶ 20183. Sale, redemption or other disposition of nonqualified allocations or per-unit retain certificates. The gain on redemption, sale or other disposition by any person of a nonqualified written notice of allocation or a nonqualified per-unit retain certificate is ordinary income to the extent of the excess of the stated dollar amount over basis.¹⁸

But if the nonqualified written notice of allocation was paid as a patronage dividend, the gain isn't included in gross income to the extent it's properly taken into account as an adjustment to basis of property, or attributable to personal, living, or family items.¹⁹

Farmers' Co-ops

¶ 20184. Nonpatronage distributions deductible by exempt farmers' co-ops. An exempt farmers' co-op may deduct these nonpatronage distributions (in addition to patronage dividend and per-unit retain allocations deductions, see ¶ 20178): (1) dividends paid during the tax year on its capital stock and on any other evidence of proprietary interest in the co-op;²⁰ (2) amounts paid in money, qualified written notices of allocation (¶ 20181), or other property (except nonqualified written notices of allocation) to patrons on a patronage basis, out of earnings from nonpatronage sources, or from business done for the U.S. or its agencies;²¹ and (3) amounts paid in

money or other property (except written notices of allocation) in redemption of nonqualified written notices of allocation issued to patrons on a patronage basis with respect to earnings from nonpatronage sources, or from business done for the U.S. or its agencies.²²

If the co-op's patrons don't present its nonqualified allocations or certificates aren't presented for payment for an unduly extended period, the co-op's tax is adjusted to avoid income distortion.²³

¶ 20185. Which farmers' co-ops are exempt. Two kinds of farmers' co-ops are exempt co-ops: (1) marketing co-ops engaged in marketing farm products for its member farmers, fruit growers, livestock growers, dairymen, etc.,²⁴ and (2) purchasing co-ops engaged in buying supplies and equipment for the use of the member farmers, etc., described in (1), above, which are turned over to them at actual cost, plus necessary expenses.²⁵

Farmers' co-ops file a return on Form 990-C, whether or not they are subject to regular corporate taxes.²⁶

¶ 20186. Exempt farmers' co-ops may have stock and reserves. A farmer's co-op can be exempt even if it has capital stock, if: (1) the dividend rate can't exceed the greater of (a) the legal rate of interest for the state of incorporation or (b) 8% of the value of the consideration for which the stock was issued; and (2) substantially all the stock is owned by producers who, on a current basis,²⁷ market or buy through the co-op.²⁸

The co-op may accumulate and maintain reserves required by state law or reasonable reserves for necessary purposes and still be exempt.²⁹

¶ 20187. Farmers' co-ops must apply for exemption—Form 1028. To qualify as an exempt farmers' marketing or producing co-op, the organization must file Form 1028 as prescribed in the instructions.³⁰

¶ 20200. Cooperative and Condominium Housing.

Cooperative housing corporations (co-ops) and condominiums (condo) are legal forms used for group ownership of multi-unit housing. Both forms of group ownership generally provide the same tax treatment for the owners as individual ownership.

For cooperatives generally, see ¶ 20175 *et seq.*

¶ 20201. Cooperatives (co-ops) and condominiums (condos) distinguished. A co-op is a corporation that meets the four requirements at ¶ 19428.¹

observation: In the co-op form of group ownership, title to the entire multi-unit property is held by

the co-op. The stockholders occupy their dwelling units under occupancy agreements, generally in the same form as ordinary apartment leases, calling for payment of maintenance charges as fixed by the corporation's board of directors.

observation: In the condo form of group ownership, title to the multi-unit property is held by the

15. Code Sec. 1385(a).

16. Code Sec. 1385(b).

17. Code Sec. 246(a)(1).

18. Code Sec. 1385(c)(2)(C); Reg § 1.1385-1(b)(1).

19. Code Sec. 1385(b).

20. Code Sec. 1382(c)(1); Reg § 1.1382-3(b).

21. Code Sec. 1382(c)(2)(A); Reg § 1.1382-3(c).

22. Code Sec. 1382(c)(2)(B); Reg § 1.1382-3(d).

23. Code Sec. 1383(a); Code Sec. 1383(b)(1); Reg § 1.1383-1(a); Reg § 1.1383-1(c).

24. Code Sec. 521(b)(1); Code Sec. 521(b)(4); Reg § 1.521-1(a)(1).

25. Code Sec. 521(b)(1); Code Sec. 521(b)(4); Reg § 1.521-1(b).

26. Reg § 1.6012-2(f).

27. *Co-operative Grain & Supply Co v. Com.*, (1969, CA8) 23 AFTR 2d 69-804, 407 F2d 1158, 69-1 USTC ¶ 9247; Rev Proc 73-39, 1973-2 CB 502.

28. Code Sec. 521(b)(2).

29. Code Sec. 521(b)(3).

30. Reg § 1.521-1(e); Rev Proc 90-27, 1990-1 CB 514.

1. Code Sec. 216(b).